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In the Supreme Court of the United States

October Term, 2003

FRANK BIEHL and BARBARA BIEHL
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. WHETHER, UNDER SECTION 61 OF THE INTERNAL REVENUE CODE, 26 U.S.C. 61(a), A TAXPAYER'S GROSS INCOME FROM THE PROCEEDS OF LITIGATION INCLUDES THE PORTION OF HIS DAMAGES RECOVERY THAT IS PAID TO HIS ATTORNEYS PURSUANT TO A CONTINGENT FEE AGREEMENT.

II. WHETHER ATTORNEY FEES WERE REIMBURSED PURSUANT TO AN "ACCOUNTABLE PLAN" WITHIN THE MEANING OF IRC §62(a)(2)(A).

LIST OF PARTIES

The parties to the instant proceedings are Frank Biehl and Barbara Biehl, petitioners, and the Commissioner of Internal Revenue, respondent. The parties at the United States Tax Court for this action were:

Petitioners: Frank Biehl and Barbara Biehl
Respondent: Commissioner of Internal Revenue

There are no other known parties in interest.

TABLE OF CONTENTS

QUESTIONS PRESENTED i

LIST OF PARTIES ii

TABLE OF AUTHORITIES vi

OPINIONS BELOW 1

JURISDICTION 2

STATUTES INVOLVED 2

STATEMENT OF THE CASE 3

I. **FACTS** 3

II. **PROCEEDINGS BELOW** 4

REASONS FOR GRANTING THE WRIT 6

I. THE PETITION SHOULD BE GRANTED BECAUSE A CONTROLLING ISSUE IS PRESENTLY BEFORE THE COURT IN BANKS V. COMMISSIONER. 6

II. THE PETITION SHOULD BE GRANTED BECAUSE OF THE IMPORTANCE OF THE ISSUE, ITS NATIONAL EFFECT ON EMPLOYMENT-RELATED LITIGATION AND ITS NEGATION OF IMPORTANT CIVIL RIGHTS PRINCIPLES. 6

1. *THE PHRASE "IN CONNECTION WITH" HAS HISTORICALLY BEEN GIVEN A BROAD INTERPRETA-*

TION. THE COURTS BELOW ERRED BY CONSTRUING "IN CONNECTION WITH" NARROWLY 7

A. "In Connection With" Has Been Accorded a Broad Judicial Interpretation, Which Congress Approved When it Re-enacted § 62(a)(2)(A) in 1986 10

B. The Narrow Construction of § 62(a)(2)(A) is Inconsistent With the Tax Court's Own Prior Decisions 12

2. *THE TAX COURT ERRED BY DEFINING ACCOUNTABLE PLANS TO REQUIRE THE EMPLOYER TO BENEFIT FROM AN EXPENSE WHEN THE EXPENSE IS INCURRED AND BY RESTRICTING ACCOUNTABLE PLANS TO CURRENT EMPLOYEES* 14

A. Neither the Statute Nor the Regulations Require That the Employer Benefit from an Expense When the Expense Is Incurred 14

B. Neither the Statute Nor the Regulations Prevent a Payment by an Employer to a Former Employee from Qualifying as a Reimbursement under § 62(a)(2)(A) 16

C. The Language of § 62(a)(2)(A) Can Plausibly Be Construed to Cover the Payment of Attorney's Fees by an Employer to a Former Employee. 18

D. The Cases Cited by the Tax Court as Supporting an Employer Benefit Requirement and Current Employment are not on Point and Can Easily be Distinguished. 22

CONCLUSION 25

APPENDICES:

A. Opinion of the Ninth Circuit Court of Appeals (December 12, 2003) 1a

B. Order of the Ninth Circuit Court of Appeals Denying Petition for Rehearing and Rejecting Suggestion for Rehearing *en Banc* (February 10, 2004) 10a

C. Opinion of the United States Tax Court (118 T.C. 467 (2002)) 11a

TABLE OF AUTHORITIES

STATUTES:

26 U.S. C. (Internal Revenue Code)

§ 132(d) 18

§ 162(a) 9, 10, 14

§ 22(n)(3) (1939 Code) 19

§ 62 2

§ 62(c) 7, 21

28 U.S.C.

§ 1254(1) 2

§ 2101(c) 2

CASES:

Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995) 9, 10, 24

Butler v. Commissioner, 17 T.C. 675 (1951) 19

Consumer Product Safety Commission v. GTE Sylvania, 447 U.S. 102 (1980) 16

Gates v. Deukmejian, 987 F.2d 1392 (9th Cir. 1992) 6

Kornhauser v. United States, 276 U.S. 145 (1928) 19

Lickert v. Commissioner, T.C. Memo 1964-47 . . . . . 22, 24

McKay v. Commissioner, 102 T.C. 465 (1994), vacated and remanded on another issue, 84 F.3d 433 (5th Cir. 1996)

. . . . . 9, 19, 24

McKeague v. United States, 12 C. Ct. 671 (1987), affd without published opinion 852 F.2d 1294 (Fed. Cir. 1988)

. . . . . 19, 24

O'Malley v. Commissioner, 91 T.C. 352 (1988) 19

Price v. Commissioner, T.C. Memo 1971-323 . . . . 22, 24, 25

Price, United States v., 361 U.S. 304 (1960) 16

Primuth v. Commissioner, 54 T.C. 374 (1970). 19

Rietzke v. Commissioner, 40 T.C. 443 (1963) 22-24

S. D. Myers, Inc. v. City and County of San Francisco, 253 F.3d 461 (9th Cir. 2001) 6

Shotgun Delivery, Inc. v. U.S., 269 F. 3d 969 (9th Cir. 2001) 22

Sinyard v. Commissioner, 268 F.3d 756 (9th Cir. 2001) 9

Snow v. Commissioner, 416 U.S. 500 (1974) 11

Spina v. Forest Preserve District of Cook County, 207 F. Supp. 2d 764 (N.D. Ill. 2002) 17

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

Petitioners Frank Biehl and Barbara Biehl pray that a writ of certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Ninth Circuit entered in this matter on December 12, 2003. (App. A, *infra*, at 1a).

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit (App. A, *infra*, at 1a) is reported at F.3d (9th Cir. 2003). The Order of the Ninth Circuit denying the Biehls' Petition for rehearing With Suggestion for Rehearing En Banc (App. B, *infra*, at 10a) is not reported.

The opinion of the United States Tax Court (App. C, *infra*, at 11a) is reported at 118 T.C. 467 (2002).

JURISDICTION

The Opinion of the United States Court of Appeals for the Ninth Circuit (App. A, *infra*, 1a) was filed December 12, 2003. Petitioners filed a timely petition for rehearing with suggestion for hearing *en banc* on January 13, 2004. The Ninth Circuit denied the petition for rehearing and rejected the request for hearing *en banc* by unpublished Order on February 10, 2004. (App. B, *infra*, 10a)

This Court has jurisdiction to review the judgement and opinion of the Court of Appeals pursuant to 28 U.S.C. §§ 1254(1) and 2101(c).

STATUTES INVOLVED

The pertinent portions of the statutory provisions relevant to resolution of this case are as follows:

INTERNAL REVENUE CODE, 26 U.S.C. § 62:

SEC. 62. ADJUSTED GROSS INCOME DEFINED.

(a) GENERAL RULE. – For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) TRADE AND BUSINESS DEDUCTIONS.--The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) CERTAIN TRADE AND BUSINESS DEDUCTIONS OF EMPLOYEES.

(A) REIMBURSED EXPENSES OF EMPLOYEES. – The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. The fact that the reimbursement may be provided by a third party shall not be determinative of whether or not the preceding sentence applies.

* * * * * * * *

(c) CERTAIN ARRANGEMENTS NOT TREATED AS REIMBURSEMENT ARRANGEMENTS. For purposes of subsection (a)(2)(A), an arrangement shall in no event be treated as a reimbursement or other expense allowance arrangement if –

(1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or

(2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

The substantiation requirements of the preceding sentence shall not apply to any expense to the extent that substantiation is not required under section 274(d) for such expense by reason of the regulations prescribed under the 2nd sentence thereof.

STATEMENT OF THE CASE

I. FACTS

In March of 1994, Mr. and Mrs. Biehl filed an action in Santa Clara County, California, Superior Court against North Coast

Medical, Inc. ("NCMI") and several other defendants. This action included a claim for wrongful termination relating to Frank Biehl's ("Biehl") former employment with NCMI as Vice-President/General Manager and a claim for dissolution of the corporation. These claims were bifurcated and the parties went to trial in March of 1996 on the wrongful termination claim. After trial, the jury awarded a verdict in the amount of $2,100,000 for the wrongful termination claim.

In January of 1997, the Biehls and NCMI entered into a "Confidential Settlement Agreement and Release of Claims." ("Settlement Agreement"). Pursuant to the Settlement Agreement, the Biehls requested that NCMI issue a separate check to Biehl's attorneys in the amount of $401,000. In so doing, Biehl and his attorneys sought to limit Petitioners' taxable income to the amount of $799,000.

The Biehls duly reported the $799,000 they received as income on their 1996 return. They did not report the $401,000 paid to their attorneys by NCMI, nor did they claim that amount as a deduction.

In the notice of deficiency, the IRS determined that the $401,000 paid by NCMI to the Biehls' attorneys was includible in the Biehls' gross income and was made under a nonaccountable plan and that this amount was allowable as an itemized deduction. A deficiency resulted from the IRS determination because the $401,000 attorney's fees are not deductible for purposes of the Alternative Minimum Tax ("AMT").

II. PROCEEDINGS BELOW

THE TAX COURT RULING:

This case was submitted fully stipulated to the Tax Court pursuant to Tax Court Rule 122. The Tax Court entered its Opinion on May 30, 2002, and the corresponding Decision on May 31, 2002, sustaining the IRS's deficiency determination in full. The Tax Court's opinion is reported at 118 T.C. 467 (2002).

The Tax Court sustained the IRS's determination and held that although Biehl's attorney's fee was an employee business expense

under 26 U.S.C. §162(a), [1] it did not meet the requirements of § 62(a)(2)(A), and consequently Biehl's income under the AMT was the entire $1.2 million settlement amount without a deduction for the attorney's fees. The Tax Court acknowledged this outcome "smacks of injustice." (App. C, *infra*, p. 11a).

NINTH CIRCUIT RULING:

The Ninth Circuit affirmed. It held that attorneys' fees paid in settlement of a wrongful termination suit do not satisfy the business connection requirement of § 62(a)(2)(A).

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[1]All statutory citations are to the Internal Revenue Code, Title 26 U.S.C., unless otherwise specified.

REASONS FOR GRANTING THE WRIT

I. THE PETITION SHOULD BE GRANTED BECAUSE A CONTROLLING ISSUE IS PRESENTLY BEFORE THE COURT IN CIR v. BANAITIS AND CIR v. BANKS.

The Biehls' petition for writ of certiorari should be granted because the issue that is presently before the Court in Commissioner of Internal Revenue v. Banks, No. 03-892 and Commissioner of Internal Revenue v. Banaitis, No. 03-907 (certiorari granted March 29, 2004), will control the outcome.

In this case, the Biehls did not raise the issue whether the attorney fee portion of their litigation award was taxable income to them. The Tax Court correctly noted that "It is clear under the jurisprudence of the Tax Court, and the Court of Appeals for the Ninth Circuit, to which this case would be appealable, that such a fee is not excluded from gross income under the "common law" of taxation. (footnote containing citations omitted). (*See* App. C, *infra*, p. 16a).

In the event this Court holds that such fees are **not** gross income, which is the issue presented in the Banks case, such a ruling would constitute a significant and controlling change in the law applicable herein. Appellate courts have discretion to address a new issue raised for the first time on appeal if the issue arises while the appeal is pending due to a change in the law. *See, S. D. Myers, Inc. v. City and County of San Francisco*, 253 F.3d 461, 471 (9th Cir. 2001); *Gates v. Deukmejian*, 987 F.2d 1392, 1407-08 (9th Cir. 1992).

II. THE PETITION SHOULD BE GRANTED BECAUSE OF THE IMPORTANCE OF THE ISSUE, ITS NATIONAL EFFECT ON EMPLOYMENT-RELATED LITIGATION AND ITS NEGATION OF IMPORTANT CIVIL RIGHTS PRINCIPLES.

1. *THE PHRASE "IN CONNECTION WITH" HAS HISTORICALLY BEEN GIVEN A BROAD INTERPRETATION. THE*

COURTS BELOW ERRED BY CONSTRUING "IN CONNECTION WITH" NARROWLY

The crux of this case is whether Biehl's attorney's fees were incurred "in connection with" his (former) employment, as that phrase is used in § 62(a)(2)(A). For reasons discussed *infra*, that question should be answered in the affirmative.

Biehl and his employer settled an unlawful termination of employment claim for a total of $1.2 million, with $799,000 payable to Biehl and $401,000 payable directly to Biehl's attorneys to cover their fees for legal services. The IRS determined that Biehl's income under the AMT was the full settlement amount of $1.2 million without any deduction for the $401,000 attorney's fee that was the cost of obtaining the settlement, and the Courts below sustained that determination.

Under § 62(a)(2)(A), reimbursement of expenses "paid or incurred by the taxpayer, *in connection with* the performance by him of services as an employee under a reimbursement or other expense allowance arrangement with his employer," are excluded from income. (Emphasis added). Under § 62(c) the taxpayer must be required to "substantiate the expenses covered by the arrangement" and must not be permitted "to retain any amount in excess of the substantiated expenses covered under the arrangement."[2]

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[2] Although the Tax Court did not discuss whether Biehl satisfied § 62(c), the invoices and other documentation prepared by his attorney could (and should) be treated as providing the substantiation required by § 62(c), eliminating any need to remand for such a determination.

A reimbursement arrangement must "require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement." § 62(c)(1). Biehl's fee agreement is adequately documented in the record as is the payment of $401,000 directly to his attorney.

(continued...)

In the Tax Court, Biehl argued that the attorney's fees were paid in accordance with § 62(a)(2)(A), and were therefore properly excluded from income. The Tax Court rejected Biehl's position, finding that his attorney's fees were not incurred "in connection with" his employment at NCMI. The consequence of this is that Biehl's attorney's fees are not deductible for AMT purposes. [3/]

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[2](...continued)

Regs. § 1.62-3(e) also requires that this information be provided "to the payor." The fact that NCMI paid the fee directly to Biehl's attorney establishes this was done. Even if a copy of the fee agreement was not provided to NCMI, the documentation in the record demonstrates substantial compliance. See, *American Air Filter Co. v. Commissioner,* 81 T. C. 709, 719 (1983) ("substantial compliance with regulatory requirements may suffice when such requirements are procedural and when the essential statutory purposes have been fulfilled.").

Section 62(c)(2), also provides that the reimbursement arrangement must not allow "the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement." "Whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances." Regs. § 1.62-2(f). Biehl could not have retained any excess because fees were paid directly to the attorney. Therefore, under the practical "facts and circumstances" test of Regs. § 1.62-2(f), the requirements of § 62(c)(2) are satisfied. For this reason, in the event the Court determines the Tax Court erred in its interpretation of § 62(a)(2)(A), this case does not require remand.

[3]An AMT deduction is permitted only if specific requirements set out in § 62(a)(2)(A) and (c) are met. Expenses that do not qualify under § 62(a)(2)(A) and (c) are not allowable "above the line" to

(continued...)

This is the first case in which any court has discussed in detail whether § 62(a)(2)(A) applies to the portion of a settlement allocated to an attorney's fee in employment litigation. [4] Although the Tax Court found Biehl's attorney's fee was an employee business expense under § 162(a), it held the expense did not meet the "accountable plan" requirements of § 62(a)(2)(A), therefore Biehl's income under the AMT was the entire $1.2 million without a deduction for the attorney's fee.

The Tax Court recognized this outcome "smacks of injustice." See also *Kenseth v. Commissioner*, 114 T.C. 399, 407 (2000) (same). Other courts have similarly criticized the result. The First Circuit also said it "smacks of injustice." *Alexander v. IRS*, 72 F.3d 938, 946 (1st Cir. 1995). The Ninth Circuit has called the result "anomalous" and "no doubt unintended." *Sinyard v. Commissioner*, 268 F.3d 756, 759 (9th Cir. 2001). Judge McKeown, dissenting in *Sinyard*, found the result "Draconian" and "surprising, to say the least." *Id.* at 762, 763. Nevertheless, the Courts felt the statute, the cases, the regulations, and legislative history required it to reach this undesirable and unjust result.

The Tax Court noted "It is well settled that the costs of a former employee's prosecution of a wrongful termination claim are deductible by him as a trade or business expense under section 162(a)."

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[3](...continued)
arrive at adjusted gross income under the regular tax. Expenses that are not allowable "above the line" are miscellaneous itemized deductions (unless specifically exempted). Attorney's fees are not an exempted item. § 67(b). Miscellaneous itemized deductions are not deductible under the AMT. § 56(b)(1)(A)(i).

[4] *Alexander v. Commissioner*, T. C. Memo 1995-51, affd. 72 F. 3d 938 (1st Cir. 1995) and *Brenner v. Commissioner*, T.C. Memo 2001-127, are distinguishable, because the settlement agreements in those cases did not specifically allocate a portion of the employee's recovery to the attorney's fee.

(citing *McKay v. Commissioner*, 102 T.C. 465, 488 (1994), vacated and remanded on another issue, 84 F.3d 433 (5th Cir. 1996); and *Alexander v. Commissioner*, T.C. Memo 1995-51, affd. 72 F. 3d 938 (1st Cir. 1995)). Nevertheless, it held that the connection between the attorney's fee and Biehl's performance of services as an employee was too remote to qualify under § 62(a)(2)(A):

> The attorney's fee incurred in the prosecution by a former employee of a wrongful termination claim is simply *too far removed* from the performance of an employee's regular duties to have been "in connection with the performance by him of services as an employee" of the employer.

(Appendix C, *infra*, p. 36a) (Emphasis added)

In other words, according to the Tax Court, an expense acknowledged to be incurred "in carrying on" the business of performing services as an employee under § 162(a), is too far removed to be "in connection with" the performance of services as an employee under § 62(a)(2)(A). This narrow interpretation of "in connection with" is contrary to established construction of those words.

A. "In Connection With" Has Been Accorded a Broad Judicial Interpretation, Which Congress Approved When it Re-enacted § 62(a)(2)(A) in 1986

Although the Tax Court correctly recognized that the phrase "in connection with" has been accorded a broad interpretation, it found the phrase is limited by a requirement that an expenditure must be "'integrated' or 'integral to' that to which it is allegedly connected," citing *Huntsman v. Commissioner*, 905 F.2d 1182, 1184 (8th Cir. 1990), revg. 91 T.C. 917 (1988) and *Fort Howard Corp. v. Commissioner*, 103 T.C. 345, 351 (1994). Contrary to the Tax Court's construction, "in connection with" is self-limiting and does not require any additional boundaries, such as "integrated" or "integral to." Those words add nothing to the analysis and lead to an incorrect result.

The Tax Court's interpretation is plainly inconsistent with Supreme Court precedent that the "in carrying on" language of § 162 is *more narrow* than "in connection with." *Snow v. Commissioner*, 416 U.S. 500, 503-504 (1974). See also *Huntsman*, 91 T.C. at 923-924 (Ruwe, J., dissenting, noting the *Snow* comparison of the two phrases). "In connection with" has also been accorded a broad interpretation in other statutes, outside of the Internal Revenue Code. See *Huntsman*, 905 F.2d at 1185, note 6 (citing cases demonstrating this universal broad interpretation). We have not found any case (other than the Tax Court's opinions in *Hunstman* and the present case) in which the phrase "in connection with" has been given anything other than a broad interpretation.

When Congress re-enacted § 62(a)(2)(A) in 1986, it did not change the language. Where statutory language is re-enacted in subsequent legislation, Congress is presumed to know and approve judicial constructions of that language. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 382, note 66 (1982) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it reenacts a statute without change") (citations omitted); *United States v. Merriam*, 263 U.S. 179, 187 (1923) (where a word has a judicially settled meaning, there is a presumption that Congress used it in that sense); *Midlantic Nat'l Bank v. New Jersey*, 474 U.S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific"). See also N. Singer, 2A Sutherland Statutory Construction § 49.09 (4th ed. 1984).

"In connection with" has appeared in numerous sections of the Internal Revenue Code for many years.[5] It has been in § 62(a)(2)(A) and its predecessors for almost 60 years, and has been interpreted numerous times in different sections of the Internal Revenue Code, as well at other statutes. It has been given a broad interpretation every time (except for the Tax Court's opinions in *Huntsman* and this

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[5]The Tax Court noted that it presently appears 288 times.

case). The Tax Court was bound to follow that broad interpretation. It did not, and it erred. [6]

B. The Narrow Construction of § 62(a)(2)(A) is Inconsistent With the Tax Court's Own Prior Decisions

The Tax Court's analysis is inconsistent with its own prior jurisprudence, adopting a broad construction. At first, the Tax Court adopted a narrow construction, but after it was reversed it adopted the universally accepted broad construction. In *Huntsman*, the Tax Court adopted a "limited reading" of "in connection with." *Huntsman*, 91 T.C. at 920. This construction was rejected by the Eighth Circuit, which reversed, holding that "in connection with" should be interpreted broadly and only required an association or relation. *Huntsman*, 905 F.2d at 1184. [7]

Next, in *Fort Howard*, the Tax Court, citing *Snow* and the reversal of its opinion in *Huntsman*, concluded "'In connection with' means associated with, or related. * * * Events or elements are 'connected' when they are 'logically related.'" *Fort Howard* 103 T.C. at 352

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[6]We note that the subject language in § 62(a)(2)(A) entered the Code in 1944, before "in connection with" had been construed broadly by numerous courts, as discussed above. Even though subsequent constructions related to different Code sections – and even different statutes – if it was reasonable to assume after *Snow* that "Congress intended the same liberal interpretation [of "in connection with"] be given to § 461(g)(2)," see *Huntsman*, 91 T.C. at 924 (Ruwe, J., dissenting), it is no less reasonable here, where the statute was re-enacted without change in 1986.

[7]The Eighth Circuit also noted that in *Snow* the expenses were "in connection with" even though the taxpayer there had not been engaged in business in the year the losses were incurred. This appears to dispose of the question whether § 62(a)(2)(A) embraces a former employee, discussed more fully, *infra*.

(footnote and citations omitted). The court also stated, with respect to the scope of "in connection with," that it saw "no reason to engage in difficult alternative lines of inquiry when the test provided in the statute is so readily applicable." *Id.* at 361. Dissenting in *Fort Howard*, Judge Beghe (the author of the opinion presently on appeal herein) stated "there can be no quarrel * * * that the phrase [in connection with] should be interpreted broadly." *Id.* at 377. Judge Beghe stressed that the logical relationship that should be focused on to establish there is a logical relationship is "the 'logic of events' that has to do with cause and effect relationships and necessary connections and outcomes." *Ibid*, note 2. Despite these pronouncements, in the present case the Tax Court searchingly examined difficult alternative theories (employer benefit and current employment), quarreled with the broad interpretation and ignored the logical relationship between Biehl's attorney's fees and his employment.

In *Brown Group, Inc. v. Commissioner*, 104 T.C. 105, 119-120 (1995), the Tax Court, again construing "in connection with," stated the phrase "had been, and should be, interpreted broadly," and reiterated the logically related test (even noting (at footnote 7) that its previous attempt at a narrow construction in *Huntsman* had been reversed). In a concurring opinion, Judge Beghe reiterated his observations in *Fort Howard* that logical relationship is the logic of events. 104 T.C. at 129.

Also concurring in *Brown Group*, Judge Ruwe noted "Congress intentionally used the phrase 'in connection with' in lieu of more narrow terms such as 'from' or 'for,' and a broad interpretation of the phrase is consistent with the legislative objective * * *." *Id.* at 126 (footnote and citation omitted). [8] As Judge Ruwe pointed out, Congress knows how to use narrow language if that is its intention.

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[8] As we discuss, *infra*, reimbursement arrangements were meant to equalize the tax treatment of employees with persons in business. A broad interpretation of "in connection with" is consistent with that objective.

Notwithstanding the above, the Tax Court in this case has once again attempted to narrow the construction of "in connection with," this time as it appears in § 62(a)(2)(A). The Tax Court's construction, imposing a *stricter* test even than the narrower "in carrying on" requirement of § 162(a), is clearly impermissible in light of *Snow*. The Tax Court failed to recognize that since "in carrying on" is a narrower term than "in connection with," *any* expense incurred "in carrying on" a business is necessarily incurred "in connection with" that business. Inasmuch as the Tax Court acknowledged that Biehl's attorney's fees were incurred "in carrying on" his business of being an employee of NCMI, the Tax Court erred in finding such expenses were not incurred "in connection with" that employment. For this reason, the Tax Court should be reversed.

2. *THE TAX COURT ERRED BY DEFINING ACCOUNTABLE PLANS TO REQUIRE THE EMPLOYER TO BENEFIT FROM AN EXPENSE WHEN THE EXPENSE IS INCURRED AND BY RESTRICTING ACCOUNTABLE PLANS TO CURRENT EMPLOYEES*

Although application of the correct interpretation of "in connection with" is sufficient to dispose of this case, the Tax Court's analysis is incorrect even under its limited interpretation. To support its conclusion that the "in connection with" language of § 62(a)(2)(A) was not satisfied the Court relied on two factors: (1) Biehl's employer did not benefit from the expense, and (2) Biehl incurred the expense as a former, rather than as a current, employee.

A. Neither the Statute Nor the Regulations Require That the Employer Benefit from an Expense When the Expense Is Incurred

Neither the language of the statute nor the regulations actually state that the employer must benefit from the expense (whether at the time the expense is incurred, when it is paid, or at any other time). The Tax Court, however, imposed this requirement:

> [A] reimbursed expense can be "in connection with" the performance of services as an employee *only if* it is incurred by

an employee on behalf of the employer that is providing the reimbursement.

(Appendix C, *infra*, p. 29a) (Emphasis added). Thus, according to the Tax Court, the attorney's fee did not satisfy § 62(a)(2)(A) because the fee was not incurred "for the employer's benefit," that is, "on behalf of the employer" or "for business purposes designated by the employer."

Even assuming employer benefit is required, the Tax Court's construction is overly restrictive because it does not take into account the benefit to the employer from the termination, which led to the litigation. For this reason the Tax Court's conclusion is erroneous. First, fees incurred in wrongful termination litigation are always for the benefit of the employer. Fair employment practices are encouraged and it is obviously a benefit to the employer to conform its employment practices to the required standards and to avoid future employment related claims. Additionally, if an employer believes it will benefit from firing an employee (as NCMI must have believed) – probably even knowing it is going to be sued – that should demonstrate sufficient "employer benefit" to satisfy any such requirement found in § 62(a)(2)(A).

In any event, at the time the expense was reimbursed NCMI clearly benefitted. NCMI reduced its liability on Biehl's employment related claims from the $2.1 million awarded by the jury, to $1.2 million, and it avoided further litigation of Biehl's other claims, which could have resulted in NCMI's dissolution. Given this fact, the Tax Court could only have meant that NCMI did not benefit at the time Biehl first contracted for the attorney's fee obligation. Neither the statute nor the regulations support such a distinction. If employer benefit is required – and we believe it is not – then that requirement should be satisfied if the employer benefits at any time.

The Tax Court found support for its employer benefit requirement in Committee Reports accompanying legislation in 1988 that had nothing to do with § 62(a)(2)(A). Reliance on this subsequent

legislative history is improper. This Court has cautioned against the use of post-enactment legislative history. See *Teamsters v. United States*, 431 U.S. 324, 354, n. 39 (1977) ("It is the intent of the Congress that enacted [the section] . . . that controls."); *United States v. Price,* 361 U.S. 304, 313 (1960) ("the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one"); see also, *Consumer Product Safety Commission v. GTE Sylvania, Inc.,* 447 U.S. 102, 118, n. 13 (1980) ("even when it would otherwise be useful, subsequent legislative history will rarely override a reasonable interpretation of a statute that can be gleaned from its language and the legislative history prior to its enactment."). The language of § 62(a)(2)(A), together with the contemporaneous legislative history, (discussed more fully, *infra*), can reasonably be interpreted without any limitation to expenses "on behalf of the employer" or "for business purposes designated by the employer." Since the 1988 legislation had nothing to do with § 62(a)(2)(A), it is clear that Congress' comments shed no light on Congressional intent with respect to that section. There is simply no basis to support the conclusion that these comments by the 1988 Congress were meant to define the scope or intent of legislation that had been on the books for almost 50 years, and was unchanged during that time.

For these reasons, the Tax Court erred in concluding that Biehl's expenses were not incurred in connection with his employment because they were not for the benefit of his employer.

B. Neither the Statute Nor the Regulations Prevent a Payment by an Employer to a Former Employee from Qualifying as a Reimbursement under § 62(a)(2)(A)

The Tax Court also stated that the "in connection with" language of §62(a)(2)(A) "clarifies that the expense must be incurred in the course of a *current* employer-employee relationship." (Emphasis added). Employment litigation is not limited to former employees. An employee may sue her current employer for, *e.g.*, sexual harassment or denial of equal pay, while continuing to work for the employer. See, *e.g.*, *Spina v. Forest Preserve District of Cook*

County, 207 F. Supp. 2d 764 (N.D. Ill. 2002). An expense that is "in connection with" employment when it relates to current employment should likewise be "in connection with" where the employee is fired (or is no longer an employee for any other reason). Cf., *Snow*, 416 U.S. at 502-503 (expense incurred in carrying on business even though taxpayer not in business until after year at issue); *Green v. Commissioner*, 83 T.C. 667, 686 (1984) (authorizing "temporal hiatus" between expense and a related expenditure where "in connection with" is used as a conjunctive between an expense and some other term. (Quoted in *Huntsman*, 91 T.C. at 924-925 (Ruwe, J., dissenting))).

Under the Tax Court's analysis, Biehl's legal fees would be "in connection with" his employment if he had sued, *e.g.*, on a theory of hostile workplace environment, while he was still working for NCMI, but his fees would lose their connection if he was fired in retaliation for bringing his claim.[9] Such a rule makes no sense and is neither required nor supported by the language of § 62(a)(2)(A).

There is no support in the statute or the regulations to distinguish the treatment of attorney's fees of a current employee from those of a former employee. Section 62(a)(2)(A) applies to "expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee." "In connection with" means logically

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[9]Employment related litigation is frequently imbued with great animosity. Under the Tax Court's interpretation, a vengeful employer who wanted to inflict maximum damage could fire an employee to add the additional taxes to her harm, or even to deter being sued. Since it is possible that a wrongfully terminated employee could wind up losing money even if she won her case, see *Spina*, 207 F. Supp. 764 (successful litigant owed more than $50,000 more in taxes than she recovered), a guilty employer who could lose a discrimination suit could fire the employee so she wouldn't sue and lost money vindicating her rights. A magnanimous sovereign would not demand such an egregious result. See *World Marketing, Ltd. v. Hallam*, 608 F.2d 392, 395 (9th Cir. 1979).

related. It is manifest that Biehl's attorney's fees were logically related to his employment at NCMI. It is folly to sever the connection because he was fired.

Regs. § 1.62-2(d)(1) parrots the statute, but adds the words "of the employer." Those three words were instrumental to the Tax Court's reasoning that a current employer-employee relationship is required for § 62(a)(2)(A). In finding that § 62(a)(2)(A) requires a current relationship the Tax Court referenced § 132(d) and Regs. § 1.132-1(b)(2)(i). Section 132(d) deals with working condition fringe benefits and refers to an "employee of the employer." Interpreting this statute, Regs. § 1.132-1(b)(2)(i) defines the term "employee" to mean "any individual who is currently employed by the employer." Considering that the statutory language to which these two regulations relate is different, it does not appear that either § 132(d) or Regs. § 1.132-1(b)(2)(i) are relevant to interpretation of § 62(a)(2)(A). Moreover, applying the maxim *expressio unius est exclusio alterius*, Congress' omission of the words "of the employer" from § 62(a)(2)(A) must be deemed significant. Most assuredly, in any event, that difference in language offers no assistance in interpreting Congressional intent behind § 62(a)(2)(A).

Section 62(a)(2)(A) does not distinguish between current and former employees. Attorney's fees for employment related litigation are "in connection with" the employment, whether the litigation is brought by a current or a former employee. Accordingly, the Tax Court erred in ruling that § 62(a)(2)(A) applies only to current employees.

C. The Language of § 62(a)(2)(A) Can Plausibly Be Construed to Cover the Payment of Attorney's Fees by an Employer to a Former Employee.

At best, the statute at issue in this case is susceptible of two plausible interpretations – one leading to a fair and reasonable outcome and one leading to an unjust, Draconian, anomalous, unintended and surprising outcome. In such a case the choice is clear

– the statute should be interpreted in favor of a just and reasonable outcome.

Without doubt, § 62(a)(2)(A) can be construed to cover attorney's fees in employment litigation. The phrase "expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee" has been in the Code, verbatim, for decades. It was added as section 22(n)(3) of the 1939 Code by section 8(a) of the Individual Income Tax Act of 1944, Ch. 210, 58 Stat. 231 and has remained unchanged through numerous re-enactments. This phrase has a well-defined meaning in the tax lexicon, a meaning that is not restricted to expenses for the benefit of the employer.

It is well settled that an individual may engage in the trade or business of rendering services as an employee, *O'Malley v. Commissioner*, 91 T.C. 352, 363-364 (1988); *Primuth v. Commissioner*, 54 T.C. 374, 377 (1970), and that legal expenses related to the business of being an employee are employee business expenses. See *McKay*, 102 T.C. at 489 (litigation expenses for employment related litigation are employee business expenses); *Butler v. Commissioner*, 17 T.C. 675, 681 (1951) (litigation expenses for defending a corporate officer for actions directly connected with his employment are ordinary and necessary and therefore deductible); *McKeague*, 12 Cl.Ct. 671 (litigation expenses for bringing suit against former employer for lost wages originated in trade or business and are deductible), affd. without published opinion 852 F.2d 1294 (Fed. Cir. 1988); *cf. Kornhauser v. United States*, 276 U.S. 145, 153 (1928) (stating that where suit against a taxpayer is directly connected with, or proximately resulted from, his business, the expense incurred is a business expense). The Tax Court has said, "It makes no difference whether the employee is defending himself in actions that challenge his activities as a corporate officer or the employee is bringing a suit against his former employer." *McKay*, 102 T.C. at 488 and n. 23.

The plain language of § 62(a)(2)(A) refers to *all* employee business expenses, not just expenses that are for the employer's benefit. If Congress intended to *exclude* expenses that are *not* for the benefit of the employer it would have done so. There is simply no evidence suggesting Congress intended such an exclusion.

The Tax Court erroneously relied on H. Rept. 1365, 78th Cong., 2d Sess. (1944), 1944 C.B. 821, 838-938, where Congress "described as an example of the kinds of expenses a taxpayer could deduct from gross income under § 22(n)(3) those incurred 'for his employer.'" First, there is no indication this example was intended to be exclusive, and such examples are usually *not* exclusive. Even if the clause "for his employer" as used in that Report means for the employer's benefit, the example does not consider whether an expense that is *not* for the employer's benefit would be covered. The House Report sheds no light whatsoever on expenses that are not for the employer's benefit.

A better indication of what Congress intended is found in the accompanying S. Rept. 885, 78th Cong., 2d Sess. (1944), 1944 C.B. 858, 877-878:

> Fundamentally, the deductions thus permitted to be made from gross income in arriving at adjusted gross income are those which are necessary to make as nearly equivalent as practicable the concept of adjusted gross income, when that concept is applied to different types of taxpayers deriving their income from varying sources. Such equivalence is necessary for equitable application of a mechanical tax table or a standard deduction which does not depend upon the source of income.

Thus, Congress wanted to equalize the playing field, and allow employees to deduct above the line the same expenses other in-business taxpayers could deduct, so the then-new tax tables and standard deduction would apply evenly across the board. The Tax Court's construction of § 62(a)(2)(A) violates this intent by denying a deduction that is available to other in-business taxpayers.

Nor is it absurd to include reimbursement of such expenses under § 62(a)(2)(A). Litigation costs for an employment related dispute are manifestly foreseeable. There is no apparent reason employers and employees should not be free to negotiate and provide for reimbursement of such expenses, even if the expense is not, strictly speaking,

for "the benefit of the employer." Such a construction does no violence to the statutory scheme.

There is no legislative history that gives any insight to what Congress had in mind in 1944 when it used the phrase "reimbursement and other expense allowance arrangement." It is possible that Congress had in mind a scenario under which an employer establishes an ongoing plan to reimburse current employees for specified expenses that benefit the employer (a model that is commonly understood to qualify as a reimbursement arrangement within the meaning of § 62(a)(2)(A)).[10] But it may not be the exclusive model. It is equally possible that Congress had in mind any expense that is directly connected with, or proximately resulted from, the employer-employee relationship. See *e.g.*, *Kornhauser*, 276 U.S. at 153. The Tax Court acknowledges this standard would be satisfied.[11] This appears to conform with Congress' intent to equalize the tax effect of employees and in-business taxpayers. S. Rept. 885, 78th Cong., 2d Sess. (1944), 1944 C.B. 858, 877-878. The statute is certainly capable of this construction, which has the added advantage of avoiding the conundrum that an expense which is incurred "in carrying on" a business is not incurred "in connection with" that same business, which should be foreclosed by *Snow*.

It is readily apparent that neither the statute, the regulations, the legislative history, nor the case law actually *requires* that reimburse-

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[10]The substantiation requirement of § 62(c) was not added until 1988. Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, 102 Stat. 3342.

[11]The Tax Court said:

> We acknowledge that, in a remote or an attenuated sense, the attorney's fee arose out of Mr. Biehl's performance of services because it was his prior employment and performance of services as an employee and the termination of the employment relationship that gave rise to the lawsuit.

ment occur pursuant to a continuous practice or that the employer benefit, nor does it prohibit a one-time payment or payment to a former employee. In the absence of any statutory, regulatory or judicial prohibition either interpretation is possible; therefore, § 62(a)(2)(A) could be read to apply to Biehl's expenses.

It is unknown whether Congress intended § 62(a)(2)(A) to apply to attorney's fees that are reimbursed under a settlement agreement in employment litigation. It is also unknown whether Congress intended the Code to deny any AMT deduction for such attorney's fees, particularly when denying the deduction produces an absurd outcome that grossly overstates the taxpayer's income and leads to an outcome commonly accepted as unjust and unintended. Whether § 62(a)(2)(A) is read to cover Biehl's expenses or not to cover Biehl's expenses, the result is one that Congress probably never considered.

Courts may depart from a statute's literal language to avoid an unjust result. See *Abdalla,* 647 F.2d 487, 496-97 (5th Cir. 1981); *Rod Warren Ink v. Commissioner*, 912 F.2d 325, 327 (9th Cir. 1990). See generally, N. Singer, 2A Sutherland Statutory Construction § 46.07 (4th ed. 1984). However, it is unnecessary to depart from the literal language in this case, because the language of § 62(a)(2)(A) supports the interpretation that the attorney's fees in issue were paid pursuant to an "accountable plan." Where a statute is susceptible of two interpretations, it should be interpreted in the manner that leads to a fair and just outcome, not one which leads to an outcome that is commonly condemned as "unjust."

D. The Cases Cited by the Tax Court as Supporting an Employer Benefit Requirement and Current Employment are not on Point and Can Easily be Distinguished.

The Tax Court relied on *Shotgun Delivery, Inc. v. U.S.*, 269 F. 3d 969 (9th Cir. 2001); *Rietzke v. Commissioner,* 40 T.C. 443 (1963); *Lickert v. Commissioner*, T.C. Memo 1964-47 and *Price v. Commissioner*, T.C. Memo 1971-323 in support of its interpretation, that § 62(a)(2)(A) requires an employer to benefit and a current employer-

employee relationship. These cases are all easily distinguished from *Biehl.*

The Tax Court's conclusion that *Shotgun Delivery* presupposes an employer-employee relationship at the time the expense is incurred and that the expense must be in connection with the employee's regular duties goes beyond what this Court said. The language in *Shotgun Delivery* the Tax Court relied on is merely a description of the applicable legal standard the Court applied in that case, *viz*: "expenses that employees actually incur or are 'reasonably expected to incur' in connection with their employment duties. . ." *Shotgun Delivery,* 269 F.3d at 972. First, this was not meant to be an authoritative analysis of the business connection requirement. It is nothing more than the standard the Court used and applied in that case, and insofar as it relates to the issue in this appeal is dicta. See *Pennhurst State School & Hospital v. Halderman*, 465 U.S. 89, 119 (1984) ("A point of law merely assumed in an opinion, not discussed, is not authoritative."). See also, *In re Stegall*, 865 F.2d 140, 142 (7th Cir. 1989). In any event, in today's employment environment an employer must reasonably anticipate that an employee will incur legal expenses in the event of an employment related claim. Therefore, even if the standard articulated in *Shotgun Delivery* applies, Biehl's legal expenses must be found to be within that standard.

Although the Tax Court "presupposed" current employment was required, *Shotgun Delivery* says nothing about current employment, and there is absolutely no authority for that supposition. As discussed, *supra*, there is nothing in the statute that distinguishes between current and former employees in the context of § 62(a)(2)-(A).

The three Tax Court decisions cited in the opinion below also have nothing to do with the question of whether an employer benefit is required under § 62(a)(2)(A). In *Rietzke,* 40 T.C. 443, the taxpayer claimed that $13,300 received from his employer was intended to reimburse him for entertainment expenses on behalf of his employer incurred over an indeterminate period of time. (It appears the taxpayer's contention was that the $13,300 was claimed to reimburse him for expenses incurred over the entire four-year period at issue in

that case, not only the year he received the payment.). The taxpayer failed to provide substantiation that the expenses were actually incurred in any amount greater than the $900 per year which had already been allowed by the IRS. The language from *Rietzke* the Tax Court cites in Biehl is merely a paraphrase of § 62, not an authoritative analysis. See *Pennhurst State School*, 465 U.S.at 119. See also *In re Stegall*, 865 F.2d at 142. The Tax Court in *Rietzke* had no occasion to, and did not, consider whether employer benefit was a requirement of a reimbursement plan.

In *Lickert,* T.C. Memo 1964-47, the primary issue was whether the taxpayer had adequately substantiated his expenses. The court held that diary entries made by the taxpayer provided adequate substantiation in the absence of receipts. The court said "[i]t is true that ordinarily an employee must carry the burden of proving that reimbursed expenditures represent ordinary and necessary expenses *of his employer's business* to be deductible or excludable by the employee." (Emphasis added). The court was concerned over the *proximate relationship* of the expenses to the employer's business and resolved that question in the taxpayer's favor. Since the focus was on whether the expenses were business expenses of the *employer*, *Lickert* provides no support about employer benefit as it relates to plans intended to reimburse *employee* expenses, reimbursable under § 62(a)(2)(A). See, *McKay,* 102 T.C. at 489; *Alexander v. Commissioner,* TC Memo 1995-51; *McKeague v. United States*, 12 C. Ct. 671 (1987), affd without published opinion 852 F.2d 1294 (Fed. Cir. 1988).

In *Price*, T.C. Memo 1971-323, the taxpayer paid $307.25 out of his own funds for an expense of his employer. His employer also paid him $12,000 as reimbursement for expenses he paid personally for the employer's business. The taxpayer excluded the $12,000 reimbursement and deducted the $307.25 in addition, claiming his actual expenditures exceeded the reimbursement. This deduction was disallowed because it was the employer's expense that the taxpayer was under no obligation to pay. The Court noted that reimbursed expenses are deductible by the employee in computing adjusted gross income (*i.e.*, above the line) "when an employee incurs such

expenses [necessary and ordinary business expenses of the employer] on behalf of his employer under a reimbursement agreement with such employer." *Price*, T.C. Memo 1971-323. Thus, *Price* has nothing to do with the question whether a reimbursable expense *must* benefit the employer.

The references in all four cases to reimbursed expenses as incurred "in connection with employment duties" or "on behalf of the employer" were, at best, dicta. None of the opinions considered whether the expense would qualify under §62(a)(2)(A) even if the employer did not benefit and the expense was not incurred by a current employee.

CONCLUSION

Accordingly, the Biehls respectfully request that their petition for writ of certiorari be granted.

Respectfully Submitted,

David M. Kirsch
Counsel for Petitioners

Dated: May 10, 2004

(Appendices follow)

APPENDIX A

FOR PUBLICATION
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FRANK BIEHL; BARBARA BIEHL,
Petitioners-Appellants,

No. 02-72723
Tax Ct. No. 422-00

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from a Decision of the

United States Tax Court

Argued and Submitted

November 5, 2003 – San Francisco, California

Filed December 12, 2003

Before: David R. Thompson, Stephen S. Trott,
Circuit Judges, and Charles R. Weiner,* Senior Judge.

Opinion by Judge Trott

*The Honorable Charles R. Weiner, Senior District Judge for Eastern Pennsylvania sitting by designation.

COUNSEL

David M. Kirsch, San Jose, California, for the petitioners-appellants.

Kenneth W. Rosenburg, Tax Division Department of Justice, Washington, D.C., for the respondent-appellee.

Stephen Bruce Cohen, Georgetown University Law Center, Washington, D.C., amicus curiae in support of the appellants.

OPINION

TROTT, Circuit Judge:

Frank and Barbara Biehl ("Biehls") appeal the decision of the United States Tax Court that the attorneys' fees paid to their lawyers, pursuant to a settlement agreement with Mr. Biehl's previous employer, must be treated as a miscellaneous itemized deduction rather than an adjustment to gross income stemming from a reimbursed employee expense under I.R.C. § 62(a)(2)(A). [1] We agree with the Tax Court that the plain language of § 62(a)(2)(A), the regulations explaining that provision, and its legislative history support the conclusion that Congress did not intend for attorneys' fees of a former employee in a wrongful termination action against his former employer to qualify as having been paid under an employee reimbursement or other expense allowance arrangement.

BACKGROUND

A.

The facts are set forth as stipulated by the parties before the Tax Court. In 1994, the Biehls brought suit against Mr. Biehl's former employer, North Coast Medical, Inc. ("NCMI"), alleging, *inter alia,* wrongful termination of Mr. Biehl's employment. On December 31, 1996, following an unfavorable jury verdict, NCMI agreed to settle the claim for $1.2 million. In an effort to limit their taxable income, the Biehls requested, and NCMI agreed, that a separate check be issued to the Biehls' attorney for attorneys' fees in the amount of $401,000. The Biehls reported only the remaining $799,000 as income on their 1996 tax return.

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code.

The Commissioner issued a notice of deficiency based on a determination that the applicable law required the Biehls to include the $401,000 in their adjusted gross income. Although the Commissioner determined also that the Biehls qualified for a miscellaneous itemized deduction under § 162, the general provision for the deduction of a trade or business expense, the Biehls could not reap any benefits from this potential deduction because in computing the alternative minimum tax ("AMT"), § 56(b)(1)(A)(I) does not allow *any* miscellaneous deductions. [2/] What this case boils down to is an effort by the Biehls to circumvent the restrictive, and often criticized, provisions of the AMT by claiming an "above-the-line" deduction under § 62.

B.

Section 62 provides, in relevant part:

§ 62. Adjusted gross income defined

(a) General rule. — For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions. — The deductions allowed by this chapter . . . which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) Certain trade and business deduction of employees. —

(A) Reimbursed expenses of employees. —The deductions allowed by [section 162] which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reim-

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[2]56(b)(1)(A)(i) reads, "No deduction shall be allowed for any miscellaneous itemized deduction . . . ."

bursement or other expense allowance arrangement with his employer.

(c) Certain arrangements not treated as reimbursement arrangements. — For purposes of subsection (a)(2)(A), an arrangement shall in no event be treated as a reimbursement or other expense allowance arrangement if —

(1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or

(2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

C.

The Tax Court analyzed the Biehls' contested deduction under the regulatory framework set forth in section 1.62-2 of the Treasury Regulations. The court adopted the Regulation's three prong approach to determine whether a deduction is permitted under § 62. According to the court, a reimbursement arrangement is considered an "accountable plan," and thus eligible for an above-the-line deduction, if it satisfies subsections (d), (e), and (f) of Treasury Regulation § 1.62-2. Subsection (d) incorporates the language of § 62(a)(2)(A) in setting forth what is labeled the "business connection" requirement. Subsection (e), entitled "Substantiation," discusses the level of specificity necessary to properly identify the expense, and subsection (f), entitled "Returning amounts in excess of expenses," limits eligible arrangements to those that require the employee to return amounts in excess of actual expenses. The Tax Court held that the failure to satisfy subsection (d)'s business connection requirement was dispositive, and thus did not reach the other two prongs. The Tax Court said,

> It is a well-settled axiom that the touchstone of the employer-employee relationship is the employer's dominion and control over, or right to control, the

> services performed by the employee. *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992); *Gen. Inv. Corp. v. United States*, 823 F.2d 337, 341 (9th Cir. 1987). That touchstone is missing when the expense is incurred after the relationship has ended. If the former employee is no longer under the dominion and control of the former employer, the expense cannot be properly characterized as having been "paid or incurred by the employee in connection with the performance of services as an employee of the employer." In such a case, as in the case at hand, the expense has a "connection" to the employ-ee's performance of services only in the attenuated or remote sense that the expense can be considered to relate back to, or to have arisen from, the employment relationship.

118 T.C. 467, 482-83 (2002).

JURISDICTION AND STANDARD OF REVIEW

We have jurisdiction pursuant to 26 U.S.C. § 7482. We review de novo the Tax Court's conclusions of law, including construction of the tax code. *Best Life Assur. Co. of Cal. v. Comm'r*, 281 F.3d 828, 839 (9th Cir. 2002).

DISCUSSION

We agree with the Tax Court that attorneys' fees paid in settlement of a wrongful termination suit do not satisfy the business connection requirement of § 62(a)(2)(A). This determination is supported by the plain language of the statute, the Treasury Regulations, and the legislative history surrounding both the enactment of the statute and subsequent revisions.

[1] As discussed in Treasury Regulation § 1.62-2(c)(3), "[i]f an arrangement does not satisfy one or more of the requirements of

paragraphs (d) [business connection requirement], (e), or (f) of this section, all amounts paid under the arrangement are treated as paid under a 'nonaccountable plan.' " In § 1.62-2(c)(5) the regulations go on to say that "[a]mounts treated as paid under a nonaccountable plan are included in the employee's gross income, . . . [and] may be deducted, . . . but only as a miscellaneous itemized deduction subject to the limitations applicable to such expenses." Treas. Reg. § 1.62-2(c)(5) (as amended in 1997). Therefore, the Tax Court properly held that the failure to satisfy the business connection requirement precluded an above-the-line deduction in accordance with § 62(a)(2)(A).

Statutory Interpretation

[2] "Statutory interpretation begins with the plain meaning of the statute's language." *Botosan v. Paul McNally Realty*, 216 F.3d 827, 831 (9th Cir. 2000). Section 62(a)(2)(A) specifically requires that the expense be "in connection with the *performance* by [the taxpayer] of *services* as an *employee*." (emphasis added). Congress's use of the words "performance" and "employee" dictates that, in order to be deductible, the reimbursed expenses must be incurred during the course of employment. The phrase "services as an employee" further connotes duties carried out for, or on behalf of, the employer. When the Biehls brought their lawsuit, Mr. Biehl was no longer performing services as an employee of NCMI. Thus, according to the plain meaning, the statutory requirements of § 62(a)(2)(A) are not satisfied.

[3] Although it may be true, as the Biehls contend, that the lawsuit arose out of Mr. Biehl's former employment, that determination is not sufficient to qualify attorneys' fees for a deduction under § 62(a)(2)(A). As discussed in the Tax Court opinion, "[t]he proper inquiry in deciding whether an expense has a 'business connection' is what the expenditure was 'in connection with,' and not simply whether the expenditure arose from, or had its origins in, the taxpayer's trade or business." *Biehl*, 118 T.C. at 480. Whereas § 62(a)(1) only requires the expense be "attributable to a trade or

business," the language in § 62(a)(2)(A) is much more definite. For a reimbursable employee expense to qualify for an above the line deduction, not only must it be attributable to a trade or business, but it must also have been incurred during the course of "performance . . . of services as an employee."

I.R.C. §62(a)(2)(A). Had Congress intended to open the flood-gates to all expenses incurred in connection with *employment* it could have done so. A straightforward reading of § 62(a)(2)(A), especially when compared with § 61(a)(1), does not support such an expansive approach.

Treasury Regulations

[4] The Treasury Regulations provide further support for the more narrow application of the business connection requirement. Treasury Regulations § 1.62-2(b) and (d) define the scope of § 62(a)(2)(A), and for the most part reiterate the statutory language. However, these sections of the regulations add that the performance of services must be "as an employee *of the employer*." Treas. Reg. § 1.62-2(b), (d) (as amended in 2003) (emphasis added). These three additional words reconfirm that the expenses must have been incurred on behalf of the employer within a current employment relationship. In addition, §1.62-2(d) unambiguously states that the reimbursement payment must be received from the employer "*for whom* the employee performs a service as an employee of the employer." Treas. Reg. § 1.62-2(d) (as amended in 2003) (emphasis added). This language presupposes the presence of a beneficial relationship, thus undermining the Biehls' contention that the legal expenses did not necessarily need to be incurred on behalf of NCMI.

Legislative History

[5] The legislative history surrounding this section further indicates that Congress did not intend to allow attorney fees incurred during adversarial employment litigation to be deductible under § 62. The *General Explanation of the Tax Reform Act of 1986* defines an

employee business expense as "a cost incurred by an employee in the course of performing his or her job." Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 78 (Comm. Print 1987). This strongly suggests that costs incurred after employment has terminated, such as wrongful termination litigation expenses, do not qualify.

In addition the House Conference Report accompanying the enactment of § 62(c) explains the Tax Reform Act of 1986 by stating that "Congress viewed an employer's agreement to reimburse certain expenditures pursuant to such [a reimbursement] arrangement as evidence that the item was a bona fide, ordinary, and necessary expense of the employer's business, and that in effect the employee was acting as an agent of the employer in paying for the item." H.R. Conf. Rep. No. 100998, at 203 (1988). When the deduction is framed in terms of an agency relationship it is clear that Congress intended to limit the deduction to those situations where there was a current employer-employee relationship, and the expense was incurred on behalf of the employer. In this situation, Mr. Biehl had been terminated from employment and thus could not be considered an agent of NCMI.

Last but not least, the Senate Conference Report accompanying a technical amendment to the code clarifies that Congress intended the deduction to apply in situations where the expense was incurred on behalf of the employer. S. Rep. No. 100-445 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3530, 4533. The report states that, "an employee who incurs business expenses *on behalf of* the employer and is reimbursed for those expenses pursuant to a reimbursement arrangement is permitted an above-the-line deduction for those expenses . . . ." *Id.* at 7.

Not only do we interpret Congressional intent in this manner, the Biehls' attorney, as well as the amici advocating the Biehls' position, conceded during oral argument that Congress did not anticipate or consider an application of the disputed statute to the scenario and context presented by this case. We will not stretch the

statutory language to cover a situation not contemplated by Congress. *See NLRB v. Catholic Bishop of Chicago*, 440 U.S. 490, 504-07 (1979) (explaining that courts should refrain from construing statutes to have an effect not intended by Congress); *U.S. v. Harvis Const. Co., Inc.*, 857 F.2d 1360, 1365 (9th Cir. 1988) ("The proper function of a court is to construe and apply statutes, not write them."); *United States ex rel. Fine v. Chevron, U.S.A., Inc.*, 72 F.3d 740, 747-48 (9th Cir. 1995) (en banc) (Trott, J., concurring) (stating that courts should not read statutes to produce a result not intended).

Case law

This issue has not been decided by the Ninth Circuit. Thus, the Biehls rely in some measure on the First Circuit case *Alexander v. Comm'r* for the proposition that the employee need not be currently employed nor incur expenses on the employ-er's behalf to take advantage of the § 62(a)(2)(A) deduction. 72 F.3d 938 (1st Cir. 1995). *Alexander*, however, dealt with § 62(a)(1), not § 62(a)(2)(A). § 62(a)(1) covers only non-employee business expenses. *Employee* business expenses fall under § 62(a)(2)(A), and § 62(a)(2)(A) has restrictive language that § 62(a)(1) does not. In fact, as the Biehls concede in their brief, although somewhat helpful, *Alexander* is "distinguishable."

CONCLUSION

The Biehls fail to establish the business connection as is required under § 62(a)(2)(A). Even though, preliminarily, these fees might broadly qualify for treatment as a deduction under § 162(a), the legal fees associated with a wrongful termination lawsuit against a former employer are not "in connection with the performance . . . of services as an employee." This issue is dispositive, and therefore we do not address whether there was a reimbursement arrangement. If this result strikes some as bad policy, or unfair, the remedy is with Congress, not the courts.

AFFIRMED

APPENDIX B

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

FRANK BIEHL;	No. 02-72723
BARBARA BIEHL,	IRS No. 422-00
Petitioners - Appellants,	Northern District of California
v.	San Jose
COMMISSIONER OF	
INTERNAL REVENUE,	ORDER
Respondent-Appellee.	

Before: THOMPSON, TROTT, Circuit Judges and Weiner* , Senior Judge

Judge Trott has voted to deny the petitioner for rehearing en banc, and Judges Thompson and Weiner so recommend.

The full court has been advised of the suggestion for rehearing en banc and no judge of the court has requested a vote on it. Fed. R. App. P. 35(b).

The petition for rehearing en banc is DENIED.

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* Hon. Charles R. Weiner, Senior District Judge for Eastern Pennsylvania, sitting by designation.

APPENDIX C

118 T.C No. 29

UNITED STATES TAX COURT

FRANK AND BARBARA BIEHL, Petitioners v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 422-00. Filed May 30, 2002.

Ps are H and W. H, a shareholder and former employee of D Corp., filed suit with W, also a shareholder of D, against D and its other shareholders for wrongful termination of H's employment and for dissolution of D. Following a jury verdict of $2.1 million in favor of H on his wrongful termination claim, Ps and D negotiated a global settlement under which D in 1996 paid a total of $1.2 million to settle H's wrongful termination claim, $799,000 to H and $401,000 to Ps' attorney; D settled Ps' dissolution claims by agreeing to buy back Ps' shares in D in an installment sale with payments scheduled to begin in 1997. Ps did not report or disclose on their 1996 joint income tax return the $401,000 payment to their attorney, on the ground that D made the payment pursuant to "a reimbursement or other expense allowance arrangement" under I.R.C. sec. 62(a)(2)(A) and sec. 1.62-2, Income Tax Regs. R determined that the payment to Ps' attorney had to be included in Ps' gross income and did not qualify as paid pursuant to an "accountable plan" under sec. 1.62-2, Income Tax Regs. R therefore determined that Ps were required to treat the payment as an itemized deduction, rather than a deduction in computing adjusted gross income. Such an itemized deduction is disallowed as

a deduction under I.R.C. sec. 56(b)(1)(A)(i) in computing income subject to alternative minimum tax under I.R.C. sec. 55.

Held: Amounts paid by a former employer to a former employee in settlement of his wrongful termination claim fail to satisfy the first requirement for an accountable plan, the "business connection" requirement of I.R.C. sec. 62(a)(2)(A) as set forth in sec. 1.62-2(d)(1), Income Tax Regs.; the payment to Ps' attorneys is included in Ps' gross income and is treated as an itemized deduction.

David M. Kirsch, for petitioners.

Julie A. Fields, for respondent.

OPINION

BEGHE, Judge: This case is before the Court fully stipulated under Rule 122. [3/] Respondent determined a deficiency of $97,833 in petitioners' 1996 Federal income tax. The issue for decision is whether petitioners may treat a certain attorney's fee as paid under "a reimbursement or other expense allowance arrangement" as defined in section 62(a)(2)(A) and (c) so as to be excluded from gross income or deducted in arriving at adjusted gross income under section 62(a). Respondent contends that the fee must be included in gross income and treated as a miscellaneous itemized deduction from adjusted gross income, subject to the 2-percent floor under section 67(a) and disallowed as a deduction under section 56 in computing income subject to the alternative minimum tax (AMT) under section 55. We hold for respondent that the fee must be treated as a miscellaneous itemized deduction.

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[3]All Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the year at issue, unless otherwise specified.

Background

Petitioners Frank and Barbara Biehl (Mr. Biehl and Mrs. Biehl) resided in San Jose, California, when they filed the petition.

Mr. Biehl was an employee, officer, shareholder, and director of North Coast Medical, Inc. (NCMI), a manufacturer and distributor of medical supplies. Mrs. Biehl was also a shareholder of NCMI.

On December 6, 1990, petitioners entered into a "shareholders agreement" with NCMI and its other shareholders. The shareholders agreement provided, among other things, that, for any suit brought for breach of the agreement, the prevailing party would be entitled to recover all costs and expenses of the suit, including attorney's fees.

The shareholders agreement was primarily concerned with the imposition of restrictions and requirements regarding ownership of the shares of NCMI, providing for, among other things, restrictions on transfer, including maintenance of S election, rights of first refusal, the effects of involuntary transfers, legending shares, the status of transferees, and so on. The agreement recites that the parties intend that all present and future individual shareholders, other than Mrs. Biehl and the spouse of another shareholder employee, would be employees of the corporation, but that nothing in the agreement is intended to create or imply any obligation of NCMI to employ or continue to employ any shareholder.

In March 1994, petitioners filed an action in Santa Clara County, California, Superior Court against NCMI and its other shareholders. Petitioners were represented by the law firm of Olimpia, Whelan, & Lively. Petitioners' original fee agreement dated May 31, 1994, required petitioners to pay Olimpia, Whelan, & Lively an hourly fee for its services. The second fee agreement, dated January 25, 1996, changed the original hourly fee agreement

to a contingency fee agreement. Under the terms of the contingency fee agreement, petitioners agreed to pay Olimpia, Whelan, & Lively one-third of all sums recovered.

Petitioners' action against NCMI included a claim for wrongful termination of Mr. Biehl's employment as vice president and general manager of NCMI and a claim for dissolution of NCMI that would have entitled petitioners to be paid for their shares of NCMI. Petitioners' claims were bifurcated, and Mr. Biehl's wrongful termination claim was tried in March 1996. The jury returned a $2.1 million verdict in favor of Mr. Biehl.

Following the verdict on the wrongful termination claim, and without resolution by suit of petitioners' claims for dissolution of NCMI, petitioners and NCMI entered into negotiations looking toward a global settlement. On December 31, 1996, NCMI made two payments: $799,000 directly to Mr. Biehl and $401,000 directly to Olimpia, Whelan, & Lively. During January 1997, petitioners, NCMI, and the other defendants signed and delivered a "Confidential Settlement Agreement and Release of Claims" (settlement agreement), which set forth the terms of the settlement. The settlement agreement stated that the foregoing payments were made in settlement of Mr. Biehl's employmentrelated claims and in payment of attorney's fees related to the employment claims, respectively. The settlement agreement does not refer to NCMI's payment of the attorney's fee as a reimbursement to Mr. Biehl.

The settlement agreement resolved petitioners' dissolution claim by incorporating a stipulation for entry of judgment. The stipulation provided that the defendants would purchase petitioners' stock in NCMI for $1.2 million in an installment sale in final settlement of the corporate dissolution claim. Monthly payments on the installment sale were to begin on January 31, 1997, and continue for 143 months until December 31, 2008. The defendants were required to pay petitioners $13,321 each month, which included interest at the rate of 8-1/2 percent per year, calculated from December 31, 1996. If the defendants failed to comply with

the stipulation, judgment would be entered in favor of petitioners for the unpaid balance of the purchase price, with interest, and petitioners' reasonable attorney's fees.

NCMI issued a Form 1099 to Mr. Biehl showing $1.2 million paid to him in 1996. On October 16, 1997, petitioners filed a motion in Santa Clara County Superior Court to enforce the settlement agreement. Petitioners alleged that NCMI violated the settlement agreement by issuing one Form 1099 to Mr. Biehl for $1.2 million, rather than two Forms 1099, one to Mr. Biehl for $799,000 and one to Olimpia, Whelan, & Lively for $401,000. Petitioners' motion to enforce the settlement agreement states that the income tax consequences of the settlement were a major concern to Mr. Biehl in the settlement negotiations, and that he had been satisfied with the settlement agreement because it required NCMI to pay the attorney's fee directly to Olimpia, Whelan, & Lively. Mr. Biehl's stated concern was that if NCMI issued a single Form 1099, he would have to include $1.2 million as his income from the settlement, versus $799,000 had NCMI issued two Forms 1099. According to the motion, the tax treatment to NCMI would be the same whether it issued one Form 1099 or two Forms 1099; in either case NCMI would have a deductible expense of $1.2 million. The Superior Court granted the motion, but the record does not indicate whether one or two Forms 1099 were actually filed with respondent.

On their Form 1040, U.S. Individual Income Tax Return, for 1996, petitioners included in gross income the $799,000 NCMI directly paid to Mr. Biehl but did not report or disclose the $401,000 payment to Olimpia, Whelan, & Lively. Respondent determined in the statutory notice that petitioners should have also included in gross income and adjusted gross income the $401,000 that NCMI paid directly to their attorneys. Respondent's explanation of adjustments in the statutory notice of deficiency goes on to state: "Alternatively, if it is determined this income constitutes reimbursement, such reimbursement was made under a nonaccount-

able plan and is includible in gross income." Respondent determined that in either case petitioners would be entitled to a $401,000 miscellaneous itemized deduction from adjusted gross income. Accordingly, respondent determined the deficiency in issue of $97,833, primarily attributable to the AMT liability under section 55 resulting from disallowance of the itemized deduction under section 56(b)(1)(A)(i) in computing alternative minimum taxable income.

Discussion

This is yet another case in which a taxpayer who successfully prosecuted a wrongful termination claim against his former employer, obtaining a taxable recovery, has attempted to avoid treating as an itemized deduction from adjusted gross income the attorney's fee paid to his attorney under their contingent fee agreement. It is clear under the jurisprudence of the Tax Court, and the Court of Appeals for the Ninth Circuit, to which this case would be appealable, that such a fee is not excluded from gross income under the "common law" of taxation. [4/] Petitioners have

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[4]See Kenseth v. Commissioner, 114 T.C. 399 (2000), affd. 259 F.3d 881 (7th Cir. 2001); Banaitis v. Commissioner, T.C. Memo. 2002-5; Freeman v. Commissioner, T.C. Memo. 2001-254; Banks v. Commissioner, T.C. Memo. 2001-48. Compare Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000), revg. in part, affg. in part, and remanding T.C. Memo. 1998-362; Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000), affg. T.C. Memo. 1998-248; Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), revg. in part 28 T.C. 947 (1957), with Sinyard v. Commissioner, 268 F.3d 756 (9th Cir. 2001), affg. T.C. Memo. 1998-364; Benci-Woodward v. Commissioner, 219 F.3d 941, 943 (9th Cir. 2000), affg. T.C. Memo. 1998-395; Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000), affg. T.C. Memo. 1998-291; Brewer v.

(continued...)

therefore chosen another tack on which there is no authority on point in the Ninth Circuit. that the fee was paid by NCMI to petitioners' attorney under a "reimbursement or other expense allowance arrangement" under section 62(a)(2)(A) and (c). [5]

If petitioners' argument should succeed, petitioners' return treatment, in which they did not include in gross income or even disclose NCMI's $401,000 payment to Olimpia, Whelan, & Lively, would be vindicated; petitioners would not even be required to include the payment in gross income and claim a deduction in arriving at adjusted gross income under section 62(a)(2)(A)– the payment would be excluded from Mr. Biehl's gross income as having been paid pursuant to an "accountable plan", as defined in section 1.62-2, Income Tax Regs.

For the reasons discussed below, we hold that Mr. Biehl's attorney's fee was not paid under an employee reimbursement or other expense allowance arrangement under section 62(a)(2)(A) and (c); the statutory language, the regulations implementing these provisions, legislative history explaining them, and caselaw show that attorney's fees of former employees in wrongful termination

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[4](...continued)
Commissioner, T.C. Memo. 1997-542, affd. without published opinion 172 F.3d 875 (9th Cir. 1999); Martinez v. Commissioner, T.C. Memo. 1997-126, affd. without published opinion 166 F.3d 343 (9th Cir. 1998); Fredrickson v. Commissioner, T.C. Memo. 1997- 125, affd. without published opinion 166 F.3d 342 (9th Cir. 1998).

[5]See Brenner v. Commissioner, T.C. Memo. 2001-127 (taxpayer failed to substantiate his expenses to his former employer as required by sec. 1.62-2(e), Income Tax Regs.); Alexander v. Commissioner, T.C. Memo. 1995-51 (taxpayer did not prove that payment was made under a reimbursement arrangement with his former employer), affd. 72 F.3d 938 (1st Cir. 1995).

cases against their former employers do not qualify as having been paid under such an arrangement. The attorney's fee does not satisfy the "business connection" requirement of section 62(a)(2)(A) and its 1939 Code predecessor, as that requirement has been interpreted and continues to be applied.

Statutory Framework

Section 62 is entitled "Adjusted Gross Income Defined." [6]

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[6]The concept of "adjusted gross income" was introduced to the Federal income tax by sec. 22(n) of the 1939 Code, enacted by sec. 8(a) of the Individual Income Tax Act of 1944, ch. 210, 58 Stat. 235, as part of a package to increase revenues to finance the war effort. The package included an increase in marginal rates which reached their highest historical level with the 1944 Act; also between 1939 and 1945, the personal exemption was cut in half, from $1,000 to $500, to extend the reach of the Federal income tax to more taxpayers. The 1944 Act introduced the concept of "adjusted gross income" to implement the newly created standard deduction, which was designed to simplify the return filing process for the majority of new taxpayers and ease the administrative burden of examining the resulting increased number of tax returns.

The standard deduction simplified the process by providing individuals the option of deducting a fixed statutory estimate of their deductible nonbusiness expenses in lieu of itemizing each expense they incurred. The concept of adjusted gross income was incorporated into the Internal Revenue Code to provide, before the deduction of nonbusiness expenses, an income base to which the standard deduction would be applied. Adjusted gross income is supposed to be a rough estimate of amounts that a taxpayer has to pay for his nonbusiness expenses. When a taxpayer has determined how much income is available for his nonbusiness expenses, he may decide whether to account for his deductible nonbusiness expenses by claiming the standard deduction or by itemizing his expenses.

Under sec. 22(n)(1) of the 1939 Code and its successor in subsequent Codes, sec. 62(a)(1), business owners, partners in firms, and independent contractors could deduct all their business expenses from gross income in arriving at adjusted gross income without limitation and then either avail themselves of the standard deduction or itemize their nonbusiness expenses. Under sec. 22(n)(2) and (3) of the 1939 Code, as enacted by the 1944 Act,

(continued...)

Section 62(a) defines the adjusted gross income of an individual as gross income minus deductions enumerated in the paragraphs that follow. Paragraphs (1) (entitled "Trade and Business Deductions" – without limitation) and (2) (entitled "Certain Trade and Business Deductions of Employees" (emphasis added)) give effect to a longstanding disparity in treatment between (1) business owners, partners in firms, and independent contractors, and (2) employees. [7] The former are favored under

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[6](...continued)
employees, irrespective of whether they itemized their deductions or claimed the standard deduction, were entitled to deduct, in arriving at adjusted gross income, only– under par. (2)– "expenses of travel, meals, and lodging paid or incurred by the taxpayer while away from home in connection with the performance by him of services as an employee" and– under par. (3)– "other than expenses * * * under a reimbursement or other expense-allowance arrangement with his employer". See H. Rept. 1365, 78th Cong., 2d Sess. (1944), 1944 C.B. 821, 838-839.

[7]In the area under consideration, the deductibility of attorney's fees incurred in prosecuting unlawful termination claims, the disparity between sec. 62(a)(1) and (2)(A), and the corresponding limitations on itemized expenses and liability for the AMT of former employees are illustrated by Guill v. Commissioner, 112 T.C. 325 (1999), and Kenseth v. Commissioner, 114 T.C. 399 (2000), affd. 259 F.3d 881 (7th Cir. 2001). In Guill v. Commissioner, supra at 329-330, an independent contractor former insurance agent's attorney's fee of $151,896, incurred in prosecuting his civil action against the insurance company that fired him, were held to be deductible from gross income in arriving at adjusted gross income pursuant to sec. 62(a)(1). Conversely, in Kenseth v. Commissioner, supra at 407- 408, the taxpayer's attorney's fee of $91,800 in connection with a Federal age discrimination claim against his former employer, did not reduce
(continued...)

paragraph (1) by being allowed to deduct all expenses "attributable to a trade or business carried on by" them in computing their adjusted gross income; these expenses are coextensive with all the trade or business expenses they are entitled to deduct under section 162(a). Employees, on the other hand, are allowed by paragraph (2) to deduct only a very restricted category of their trade or business expenses in computing adjusted gross income. In addition, these expenses must be "in connection with" the employee's rendering of services to the employer.

Paragraph (2)(A) of section 62(a), [8] entitled "Reimbursed expenses of employees", provides that a taxpayer is allowed a deduction from gross income in arriving at adjusted gross income for "The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance

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[7](...continued)
his gross income from the recovery and were instead found to be allowable only as an itemized deduction from adjusted gross income. The results from the differing treatments are striking: the taxpayer in Guill enjoyed the full tax benefit of a $151,896 deduction, whereas the taxpayer in Kenseth had his deduction of $91,800 reduced by $5,298 under sec. 67 and phased out to the extent of $4,694 under sec. 68 and was subject to an AMT liability of $17,198 as a result of the disallowance of the miscellaneous itemized deduction for AMT purposes under sec. 56(b)(1)(A)(i).

[8]Sec. 62(a)(2)(B) and (C) eases the restrictions for two narrow classes of employees. Performing artists who meet the requirements of sec. 62(b) and employees of a State or a political subdivision are allowed to deduct all their otherwise allowable trade or business expenses from gross income in arriving at adjusted gross income.

a r r a n g e m e n t [9] w i t h

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[9]Sec. 62(a)(2)(A) and its statutory predecessors do not contain and have never contained a definition of the term "arrangement". However, the regulations under sec. 62(c) treat the terms "arrangement" and "plan" as synonymous. Sec. 1.62- 2(k), Income Tax Regs., provides that if "a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) and this section, all payments made under the arrangement will be treated as made under a nonaccountable plan."

Dictionary definitions of the terms "arrangement" and "plan" are helpful, although not dispositive, in indicating that the terms encompass a continuing relationship, rather than a one-shot payment of the type at issue in the case at hand. The primary definition of "arrangement" in Webster's New Universal Unabridged Dictionary 103 (2d ed. 1979) as "the act of putting in proper order; also, the state of being put in order" implies two or more elements. The use of the term in bankruptcy arrangements has multiple elements encompassing multiple creditors of the debtor whose affairs are arranged and a variety of terms and provisions regarding the payment or provisions for payment of his debts. Similarly the dictionary definitions of "plan", id. at 1372, as "a scheme for making, doing, or arranging something; a project; a program; a schedule", encompass or imply multiple elements for accomplishing something over a period of time.

The law of Federal preemption under the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 88 Stat. 829, is in accord. See Fort Halifax Packing Co. v. Coyne, 482 U.S. 1 (1987) (Maine statute requiring employers to provide onetime severance payment to employees terminated in event of plant closing not preempted by ERISA, which was intended to afford employers uniform administrative procedures governed by Federal regulations; ERISA concern arises only with respect to benefits whose provision requires ongoing administrative program to meet employer's obligations; thus Congress intended to preempt

(continued...)

his employer." Sec. 62(a)(2)(A). This language incorporates and illustrates a general proposition that applies across the board to section 62(a) and also highlights the additional specific restrictions to which employees are subject, as compared with business owners, partners in firms, and independent contractors.

The general proposition is that a deduction is allowed under section 62(a) only if it is allowable under some other provision of the Internal Revenue Code (Code). Section 62(a) merely enumerates the deductions allowed an individual in computing adjusted gross income; it does not create any new or additional deductions that are not already provided for by some other section of the Code. See sec. 1.62-1T(b), Temporary Income Tax Regs., 53 Fed. Reg. 9873 (Mar. 28, 1988). In the case of paragraphs (1) and (2)(A) of section 62(a), the allowable deduction already provided under another section of the Code is the general provision for the deductibility of trade or business expenses found in section 162(a).

The specific restriction to which employees are subject under section 62(a)(2)(A) is that their deductions allowed in computing adjusted gross income are restricted to those expenses paid or incurred "in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer." [10/] This lan

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[9](...continued)
State laws relating to plans, rather than those simply relating to benefits).

[10]Before 1986, sec. 62(2)(B) allowed employees to deduct from gross income in arriving at adjusted gross income travel expenses while away from home, transportation expenses, and expenses incurred by "outside salesmen" engaged in soliciting business for the employer's place of business. Sec. 62(2)(B), (C), and (D), I.R.C. 1954. As a result of the enactment of the Tax Reform Act
(continued...)

guage sets forth the "business connection" requirement, discussed below, and is in contrast to the loosely interpreted "attributable to a trade or business" language of section 62(a)(1) that applies to business owners, partners in firms, and independent contractors.

The scope of section 62(a)(2)(A) is further restricted by section 62(c), as enacted by the Family Support Act of 1988, Pub. L. 100-485, sec. 702, 102 Stat. 2426, effective for tax years beginning after December 31, 1988. Under section 62(c)(1) and (2), an employee business expense will be treated as covered by a "reimbursement or other expense allowance arrangement" only if the employee is required (1) "to substantiate the expenses covered by the arrangement to the person providing the reimbursement" and (2) to repay the person providing the reimbursement amounts received in "excess of the substantiated expenses covered under the arrangement." To satisfy section 62(c), the arrangement must be provided under an "accountable plan" as set forth in the regulations issued to implement section 62(c).

Regulatory Framework

The first requirement for an accountable plan is that the expense must be allowed as a deduction under section 162(a). Sec. 1.62-2(d), Income Tax Regs.; see also sec. 62(a)(2)(A). If an expense satisfies this threshold requirement, it must be scrutinized under the regulations implementing section 62(c) to determine whether it was paid under a plan that qualifies as a "reimbursement or other expense allowance arrangement". Sec. 1.62-2(c), Income Tax Regs. Under section 1.62-2(c)(1), Income Tax Regs., a

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[10](...continued)
of 1986, Pub. L. 99-514, sec. 132(b)(1), 100 Stat. 2115, and the Family Support Act of 1988, Pub. L. 100-485, sec. 702, 102 Stat. 2426, these employee expenses must satisfy the requirements of sec. 62(a)(2)(A) and (c) of present law regarding reimbursement arrangements and accountable plans.

deductible expense is paid under a qualifying "reimbursement or other expense allowance arrangement" if the arrangement meets the requirements of paragraph (d) (which incorporates the business connection requirement of section 62(a)(2)(A) into the regulations implementing section 62(c)), and paragraphs (e) and (f) (which implement the substantiation and return of excess requirements of section 62(c)). Sec. 1.62- 2(c)(2)(i), Income Tax Regs. If the "reimbursement or other expense allowance arrangement" meets these requirements, it qualifies as an "accountable plan". Sec. 1.62-2(c)(2)(i), (4), Income Tax Regs.

Section 1.62-2, Income Tax Regs., simplifies employees' reporting requirements by providing that amounts paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on Form W-2, Wage and Tax Statement, and are exempt from withholding and payment of employment taxes. Sec. 1.62-2(c)(4), Income Tax Regs. [11]

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[11]This is consistent with prior law, beginning in 1958, under which employees were not required to report amounts received as reimbursements for "travel, transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer". Sec. 1.162-17(b)(1), Income Tax Regs. Before 1958, employees were technically required to include in gross income amounts received as reimbursement and claim a corresponding deduction in arriving at adjusted gross income, resulting in a wash. See Stanley & Kilcullen, The Federal Income Tax, A Guide to the Law 25 (3d ed. 1955), 54 (2d ed. 1951). Under the regulations, the reimbursed amount was not treated as wages and therefore not subject to any withholding. See sec. 31.3121(a)-1(1), Employment Tax Regs. (1956).

Under current law, amounts paid under accountable plans are excluded from gross income as working condition fringe benefits under sec. 132(a)(3) and (d). See sec. 1.62-1T(e)(5), (continued...)

On the other hand, the regulations provide that amounts paid to an employee under a nonaccountable plan, one that does not meet all three requirements for an accountable plan, are reported as wages or other compensation on the employee's Form W-2 and are subject to withholding and payment of employment taxes. Sec. 1.62-2(c)(5), Income Tax Regs. As a result, the burden of substantiating the deductibility of the expenses is placed on the employee. Id.

The attorney's fees and costs incurred in a wrongful termination suit against a former employer do not meet the first requirement for an accountable plan, the "business connection" requirement of section 62(a)(2)(A), as incorporated in section 1.62-2(d)(1), Income Tax Regs. Because we hold that Mr. Biehl's attorney's fee does not satisfy the business connection requirement, we need not reach whether it satisfies the substantiation and return of excess requirements of paragraphs (e) and (f) of the accountable plan regulations. [12]

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[11](...continued)
Temporary Income Tax Regs., 53 Fed. Reg. 9874 (Mar. 28, 1988). The regulations on working condition fringe benefits under sec. 132 track the requirements of the accountable plan regulations under sec. 62(c), providing that a cash payment made by an employer will not qualify as a working condition fringe benefit unless the employer requires the employee to use the payment for "expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under section 162 or 167", verify that the payment was used for such expenses, and return to the employer any part of the payment not so used. Sec. 1.132-5(a)(1)(v), Income Tax Regs.; see also infra note 12.

[12]In Shotgun Delivery, Inc. v. United States, 269 F.3d 969, 972 & n.2 (9th Cir. 2001), the Court of Appeals observed:

The district court concluded that Shotgun had failed to
(continued...)

Threshold Requirement for Accountable Plan: Deductible Expense

The threshold requirement for deducting any expense from gross income in computing adjusted gross income under section 62(a) is that the expense be allowed as a deduction under some other section of the Code. For an expense to qualify as being paid under an accountable plan, it must be allowed as a deduction under section 162(a). Sec. 1.62-2(d), Income Tax Regs.

Mr. Biehl's attorney's fee satisfies the threshold requirement of deductibility under section 162(a). It is well settled that the costs of a former employee's prosecution of a wrongful termination claim are deductible by him as a trade or business expense under section 162(a). McKay v. Commissioner, 102 T.C. 465, 489 (1994), vacated and remanded on another issue 84 F.3d 433 (5th Cir. 1996); Alexander v. Commissioner, T.C. Memo. 1995-51, affd. 72 F.3d 938 (1st Cir. 1995). Section 162(a) allows a deduction for ordinary and necessary expenses incurred in the course of carrying on a trade or business. A taxpayer may engage in the trade or business of "being an employee". O'Malley v. Commissioner, 91 T.C. 352, 363-364 (1988).

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[12](...continued)
establish an adequate business connection for its reimbursement payments. 85 F. Supp. 2d at 965. This conclusion lies at the core of the summary judgment against Shotgun and is the primary bone of contention on appeal.[2]
* * *

[2] The district court also held that Shotgun had not complied with the "return of excess" requirement. 85 F. Supp. 2d at 965-66. We have no need to review that determination, as the lack of an adequate "business connection" is sufficient to invalidate Shotgun's reimbursement plan.

In McKay v. Commissioner, supra at 489, we concluded that a former employee's attorney's fees in a suit against his former employer were "incurred in the course of carrying on * * * [the taxpayer's] trade or business" as an employee. Our conclusion was based on the fact that the transaction subject to the litigation "arose in the context of the taxpayer's trade or business". Id. at 488 n.23; see also Alexander v. Commissioner, supra.

The attorney's fee Mr. Biehl incurred is deductible under section 162(a). Mr. Biehl was in the trade or business of being an employee of NCMI, and the transaction that was the subject of the lawsuit, NCMI's termination of his employment, arose in the context of Mr. Biehl's trade or business. The attorney's fee NCMI paid to Mr. Biehl's attorney satisfies the threshold requirement of section 62(a), that the fee be deductible under section 162(a). We therefore must scrutinize the attorney's fee under the business connection requirement of section 62(a)(2)(A) and the accountable plan regulations.

Business Connection Requirement

A deductible expense satisfies the business connection requirement only if it was "paid or incurred by the employee in connection with the performance of services as an employee of the employer." [13] Sec. 1.62-2(d)(1), Income Tax Regs.; see also sec.

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[13]We note that in Brenner v. Commissioner, T.C. Memo. 2001-127, we stated that expenses that "arose out of * * * [the taxpayer's] prior employment" satisfied the business connection requirement. That conclusory statement was obviously not intended to be a complete expression of the business connection requirement and the conditions for its satisfaction. Our statement was merely one of a series of assumptions by the Court in order to decide whether the taxpayer properly substantiated his expenses to his former employer. The statement was dictum because the Court had

(continued...)

62(a)(2)(A). Mr. Biehl's attorney's fee fails to satisfy the business connection requirement. An expense satisfies the business connection requirement only if it was incurred pursuant to a reimbursement arrangement by an employee performing services on behalf of the employer who is required to provide the reimbursement. Our conclusion is required by the express language of section 62(a)(1) and (2)(A), the accountable plan regulations, the caselaw, and the legislative history of reimbursement arrangements.

Section 62(a)(1) allows taxpayers to deduct from gross income in arriving at adjusted gross income those "deductions * * * which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee." An expense is "attributable to a trade or business" if the expense satisfies the origin of the claim test for the purposes of deductibility.

The difference in the ways in which paragraphs (1) and (2)(A) of section 62(a) are interpreted is highlighted by Guill v. Commissioner, 112 T.C. 325 (1999). An independent contractor former insurance agent incurred legal costs of $151,896 in prosecuting his civil action for actual and punitive damages against the insurance company that had fired him. The taxpayer recovered $51,499 in actual damages and $250,000 in punitive damages. The Commissioner conceded that the legal costs were a business expense deductible on Schedule C, Profit or Loss From Business, in computing adjusted gross income to the extent attributable to the

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[13](...continued)
previously stated, in setting forth the basis on which it was deciding the case:

> We shall deal first with the question of whether * * * [the employer] reimbursed the legal fees pursuant to, and in accordance with, Article XIII. Since, as we shall explain, we cannot make that finding, we need not consider in any detail the remaining required findings * * *

taxpayer's recovery of the actual damages. However, the Commissioner determined that the punitive damages were "other income", and that the remaining legal costs were a nonbusiness itemized deduction under section 212(1) for the production of income because they were attributable to the taxpayer's recovery of the punitive damages.

We held for the taxpayer, reasoning that the punitive damages were ancillary to the actual damages under South Carolina law, and that the attorney's fees attributable to the punitive damages recovery were sufficiently related; that is, "attributable to" the taxpayer's sole proprietor insurance business to be deductible by him under section 162(a):

> As a matter of fact, petitioner's lawsuit against Academy arose entirely from his insurance business. Each cause of action petitioner alleged in the lawsuit was spawned entirely from the fact that, after Academy fired him, it failed to honor the terms of their working agreement by not paying him the commissions to which he was entitled under their agreement. * * * [Id. at 329-330.]

As a result, we held that all the taxpayer's legal costs were "attributable to" his trade or business and were deductible on Schedule C as a business expense in arriving at adjusted gross income. See also McKay v. Commissioner, supra at 492.

Section 62(a)(2)(A), in contrast to section 62(a)(1), allows taxpayers to deduct from gross income in computing adjusted gross income deductible expenses that are "incurred by the taxpayer, in connection with the performance by him of services as an employee". The proper inquiry in deciding whether an expense has a "business connection" is what the expenditure was "in connection with", and not simply whether the expenditure arose from, or had its origins in, the taxpayer's trade or business.

At current count, the phrase "in connection with" appears 288 times in the Code. There is a body of caselaw following and relying on Snow v. Commissioner, 416 U.S. 500, 503-504 (1974), that has interpreted the phrase broadly. In Snow, the Supreme Court considered "in connection with" in the context of section 174(a)(1), which allows a taxpayer a deduction for "'experimental expenditures which are paid * * * in connection with his trade or business'". Id. at 501. The Court compared section 174(a)(1) to section 162(a), which allows a deduction for expenses paid "in carrying on a trade or business". The Court found section 162(a) to be "more narrowly written" than the "in connection" language of section 174(a)(1). Id. at 503. The Court held that section 174(a)(1) allowed a deduction even though the taxpayer had not been engaged in a trade or business in the year in which the deductions were claimed. The Court supported its holding by consulting the legislative history of section 174 and concluding that Congress intended to level the playing field "between old and oncoming businesses and the like." Id. at 504.

In Huntsman v. Commissioner, 905 F.2d 1182, 1184 (8th Cir. 1990), revg. 91 T.C. 917 (1988), the Court of Appeals for the Eighth Circuit considered section 461(g)(2), which allows a deduction for points paid "in connection with the purchase or improvement" of the taxpayer's principal residence. The issue in Huntsman was whether a taxpayer who purchased a home with a short-term 3-year loan secured by a mortgage, and replaced the short-term obligation with a permanent loan could deduct the points paid on the permanent loan. The Court of Appeals relied on Snow, to give "in connection with" a broad construction that would allow the deduction. Specifically, the Court of Appeals held that the short-term financing was "an integrated step in securing the permanent * * * [loan] to purchase the home", adopting the reasoning of Judge Ruwe's dissent in the Tax Court. Huntsman v. Commissioner, supra at 1185. The Court of Appeals emphasized that the taxpayers did not refinance their existing debt to lower

their interest rate or achieve some goal not "directly" connected with home ownership. Id. at 1182.

In Fort Howard Corp. v. Commissioner, 103 T.C. 345, 351 (1994), superseded by legislation and supplemented 107 T.C. 187 (1996), the Court analyzed section 162(k) which, at the time, prohibited deductions for amounts paid by a corporation "in connection with the redemption of its stock". The issue before the Court was whether the costs incurred in obtaining debt financing to complete a leveraged buyout that was treated as a redemption were "in connection with" the corporation's redemption of its stock and therefore nondeductible under section 162(k). Relying on Snow and Huntsman, we interpreted "in connection with" broadly to mean "associated with, or related". Id. at 352. We confirmed our reading by consulting the legislative history of section 162(k), which expressly stated that "in connection with" was intended to be construed broadly. Id. at 353. In applying the broad interpretation, we found that much of the evidence referred to the debt financing as "necessary" to the transaction. Id. at 352. In addition, the taxpayer's payment of financing costs, its receipt of the debt capital, and the redemption were events in a continuum that culminated in the redemption. Id. at 353. Similarly to the Court of Appeals for the Eighth Circuit in Huntsman, we found the financing costs were an "integral part" of a detailed plan. Id. We concluded that the financing costs were both a cause and effect of the leveraged buyout (the redemption). Id.

The foregoing authorities obviously support a broad reading of "in connection with", but that is by no means a reading without limits. The cases acknowledge as much by articulating the bounds of the phrase. Specifically, Fort Howard Corp. v. Commissioner, supra at 353, and Huntsman v. Commissioner, supra at 1185, found a "connection" existed when the expenditure at issue was "integrated" or "integral to" that to which it is allegedly connected.

In the context of reimbursement arrangements, the statute, cases, regulations, and legislative history compel the conclusion

that legal fees incurred by former employees are not "integrated" with or "integral to" the performance of services as an employee of the employer and therefore fall outside the broad scope of "in connection with". The teaching of these authorities is that a reimbursed expense can be "in connection with" the performance of services as an employee only if it is incurred by an employee on behalf of the employer that is providing the reimbursement.

The business connection requirement of section 62(a)(2)(A) was incorporated into the regulations implementing section 62(c) by section 1.62-2(d), Income Tax Regs. Under section 1.62-2(d), Income Tax Regs., a deductible expense has a business connection if it is "incurred by the employee in connection with the performance of services as an employee of the employer." (Emphasis added.) The emphasized language clarifies that the expense must be incurred in the course of a current employeremployee relationship, not merely "spawned" by or have its origin in the taxpayer's former trade or business of being an employee of his former employer. [14]

It is a well-settled axiom that the touchstone of the employer-employee relationship is the employer's dominion and control over, or right to control, the services performed by the employee. Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318 (1992); Gen. Inv. Corp. v. United States, 823 F.2d 337, 341 (9th

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[14] Property or services provided to an employee of the employer are excluded from gross income as a working condition fringe benefit under sec. 132(a)(3) to the extent that, if the employee paid for such property or services, the payment would be allowed as a deduction under sec. 162. See sec. 132(d). The regulations under sec. 132 explicitly give "employee" the meaning we find implicit in sec. 62(a)(2)(A): an "employee" for purposes of sec. 132(a)(3), concerning working condition fringe benefits, is "Any individual who is currently employed by the employer." Sec. 1.132-1(b)(2)(i), Income Tax Regs.

Cir. 1987). That touchstone is missing when the expense is incurred after the relationship has ended. If the former employee is no longer under the dominion and control of the former employer, the expense cannot be properly characterized as having been "paid or incurred by the employee in connection with the performance of services as an employee of the employer." In such a case, as in the case at hand, the expense has a "connection" to the employee's performance of services only in the attenuated or remote sense that the expense can be considered to relate back to, or to have arisen from, the employment relationship.

The caselaw involving reimbursement arrangements in continuing employment relationships is consistent with this interpretation. In Shotgun Delivery, Inc. v. United States, 269 F.3d 969, 972 (9th Cir. 2001), the Court of Appeals for the Ninth Circuit characterized reimbursable expenses under an accountable plan as those that "have a 'business connection,' that is, only permitted expenses that employees actually incur or are 'reasonably expected to incur' in connection with their employment duties" (quoting section 1.62-2(d), Income Tax Regs.). The quoted language presupposes the existence of an employeremployee relationship when the expense is incurred and indicates that the expense must be "in connection with" the performance of the regular services for which the employee is employed.

The jurisprudence of this Court is in accord with the view expressed by the Court of Appeals for the Ninth Circuit. In Rietzke v. Commissioner, 40 T.C. 443, 453 (1963), we held that "Only amounts received from an employer which are actually expended for the employer's business or for business purposes designated by the employer may be deducted from the gross income of the employee" under a reimbursement arrangement under section 62. To make this showing, we required the taxpayer to come forward with proof that he incurred expenses "on behalf" of his employer. Id.; see also Price v. Commissioner, T.C. Memo. 1971- 323 (describing expenses qualifying for section 62(a)(2)(A) as those

incurred on behalf of the employer under a reimbursement arrangement with that employer); Lickert v. Commissioner, T.C. Memo. 1964-47 (inquiring into whether the expenditures were incurred on behalf of the employer's business).

The conclusion that the expense must be incurred "in connection with" the duties performed by "an employee of the employer" is also confirmed by the legislative history of reimbursement arrangements. The predecessor of section 62(a)(2)(A) was section 22(n)(3) of the 1939 Code, as amended by the Individual Income Tax Act of 1944, ch. 210, 58 Stat. 235. In the House report, Congress described as an example of the kinds of expenses a taxpayer could deduct from gross income under section 22(n)(3) those incurred "for his employer". H. Rept. 1365, 78th Cong., 2d Sess. (1944), 1944 C.B. 821, 838-839 (emphasis added).

Similarly, in describing a technical amendment to section 62(a)(2)(A) by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, 102 Stat. 3342, the Senate report described the qualifying expenses under a reimbursement arrangement as those incurred "on behalf of the employer". S. Rept. 100-445, at 7 (1988) (emphasis added).

Finally, the conference report accompanying enactment of section 62(c) describes a "true reimbursement" as one in which the employee is reimbursed for "business expenditures incurred on the employer's behalf and for the employer's benefit." H. Conf. Re[illegible] 100-998, at 203 (1988) (emphasis added). "[I]n effect the employee was acting as an agent of the employer in paying for the item." Id. at 202 (emphasis added).

The attorney's fee paid by NCMI to Mr. Biehl's attorney does not fit within this rubric. The attorney's fee is not a business expense that NCMI incurred through the use and employment of an employee acting on its behalf. There is no evidence, as there cannot be, that NCMI instructed Mr. Biehl to incur the contingent attorney's fee on NCMI's behalf in order to further NCMI's

business of manufacturing and distributing medical supplies. When Mr. Biehl incurred the obligation to pay the attorney's fee, he had long before ceased being an employee of NCMI. He cannot be said to have been performing services as an employee of NCMI when he signed the fee agreement with Olimpia, Whelan, & Lively, or when Olimpia, Whelan, & Lively rendered legal services to Mr. Biehl pursuant to the agreement. Mr. Biehl did not incur the attorney's fee "in connection with the performance by him of services as an employee" of NCMI.

We acknowledge that, in a remote or an attenuated sense, the attorney's fee arose out of Mr. Biehl's performance of services because it was his prior employment and performance of services as an employee and the termination of the employment relationship that gave rise to the lawsuit. However, this is not an issue that is governed by the origin of the claim test, the test that concerns the general deductibility of expenses under section 162(a) or section 212. See United States v. Gilmore, 372 U.S. 39, 49 (1963); Test v. Commissioner, T.C. Memo. 2000-362; McKeague v. United States, 12 Cl. Ct. 671, 674 (1987). Deductibility under section 162(a), as we have already discussed, is the threshold requirement for an accountable plan specifically and for section 62(a) generally. The attorney's fee paid by NCMI to Mr. Biehl's attorney was clearly attributable to Mr. Biehl's trade or business of being an employee and is deductible under section 162(a). See McKay v. Commissioner, 102 T.C. 465 (1994); Alexander v. Commissioner, T.C. Memo. 1995-51. The fact that the attorney's fee somehow may have been "spawned" by the performance of prior services is much too tenuous a connection. The attorney's fee incurred in the prosecution by a former employee of a wrongful termination claim is simply too far removed from the performance of an employee's regular duties to have been incurred "in connection with the performance by him of services as an employee" of the employer.

Despite the lack of an employer-employee relationship between Mr. Biehl and NCMI when the attorney's fee was incurred

and paid, petitioners insist that the settlement agreement and the shareholders agreement establish an "arrangement" pursuant to which NCMI reimbursed Mr. Biehl's attorney's fee. Petitioners argue, as the taxpayer argued in Brenner v. Commissioner, T.C. Memo. 2001-127, regarding the indemnification provision in the former corporate employer's bylaws, that the NCMI shareholders agreement, with its provision for payment of attorney's fees and costs to the prevailing party in any suit to enforce the agreement, was a reimbursement arrangement that was implemented by the settlement agreement. This argument is misplaced.

The shareholders agreement made no provision for recovery of attorney's fees and costs for a claim for wrongful termination of employment, even any such claim by a shareholder. The shareholders agreement expressly negates any implication or inference that it created any right to employment or continued employment of any shareholder. The shareholders agreement thereby forecloses any argument that it could somehow be construed as an arrangement to reimburse a shareholder's attorney's fees incurred in prosecuting a claim for wrongful termination of employment against NCMI.

Nor can the settlement agreement standing alone create a reimbursement arrangement that satisfies the business connection requirement (or any requirement, for that matter) of the accountable plan regulations. The settlement agreement was entered into long after Mr. Biehl had performed any services as an employee of NCMI. The attorney's fee is referred to in the settlement agreement only insofar as it directs NCMI to make payment directly to Olimpia, Whelan, & Lively. The settlement agreement does not refer to the attorney's fee as being incurred "in connection with" Mr. Biehl's duties as an employee, or as having been incurred "for" NCMI or "on behalf of" NCMI or incurred by Mr. Biehl "as an agent" of NCMI, nor does it make any reference to a reimbursement arrangement.

It is clear that the terms of the settlement (and events subsequent thereto) providing for NCMI's direct payment to Mr.

Biehl's attorney of his attorney's fee in prosecuting his termination claim served Mr. Biehl's tax purposes, not any designated business purpose of NCMI. As Mr. Biehl admitted in his motion and supporting affidavit in the California Superior Court to enforce the settlement agreement, the form and method of making the settlement payment or payments was a matter to which NCMI was completely indifferent.

The exhibits made part of the stipulation of facts on which this case has been submitted for decision include not only the settlement agreement pursuant to which NCMI paid $799,000 to Mr. Biehl and $401,000 to the account of his attorney, Olimpia, Whelan, & Lively, but also petitioners' motion papers subsequently filed with the California Superior Court in the termination lawsuit to enforce the terms of the settlement. The gravamen of petitioners' motion was that NCMI had violated the terms of the settlement by issuing a single Form 1099 to Mr.Biehl. The motion asserts:

> FEB will be greatly prejudiced by receiving the single Form 1099 * * * [Had] NCM issued two separate Form 1099's, FEB and his tax advisors believe the IRS would treat only $799,000 as FEB's earned income * * * No AMT results if FEB is required to report only $799,000 as provided in the settlement by specifically separating the payments. There was no other reason to provide for separate payments to FEB and Olimpia, Whelan, and Lively.
>
> While this issue has obvious importance and potential tax consequences to FEB, to NCM it is a distinction without a difference, whether NCM issues two Form 1099's * * * or a single Form 1099 to FEB should not matter to NCM, either way, NCMI has an expense of $1,200,000 and the result to the payor is the same. Thus, whether NCM issues one or two Form 1009's is simply an administrative task.

From the foregoing admissions it can fairly be inferred that the separate payment to Mr. Biehl's attorney was negotiated on his behalf in a futile effort to minimize his Federal income tax liability, not to serve any business purpose of NCMI that could be fulfilled by any current performance of services by Mr. Biehl on behalf of NCMI.

There are intimations in the settlement documents and petitioners' briefs that the global settlement reached by NCMI and petitioners served the business purposes of NCMI by avoiding its bankruptcy and trial of petitioners' other claims, thereby enabling NCMI to continue as a viable business entity. Petitioners also intimate that the separate payment arrangement was of critical importance and that the parties could not have achieved the settlement without the separate payment arrangement.

The foregoing purposes of NCMI are within the scope of the objectives that any defendant in a lawsuit expects to achieve by a settlement. However, those purposes are too far removed from the universe of purposes of employers and employees that Congress intended to serve by enacting section 62(a)(2)(A) and (c) and their statutory predecessors, as implemented by the regulations currently in effect.

The purposes served by the statutory and regulatory requirements for reimbursement arrangements have to do with the operation and administration of the employment relationship between employers and employees. When an employee "accounts" to an employer, the employer's agreement to reimburse the employee confirms that the expense was incurred on the employer's behalf, and that the employee was performing the duties required by the employer in incurring the liability and in paying for the item. The reimbursement arrangements contemplated by section 62(a)(2)(A) and the accountable plan regulations are far removed from the case at hand and all other payments, by reimbursement or otherwise, of the attorney's fees incurred by former employees in

prosecuting wrongful termination claims against their former employers.

Conclusion

We acknowledge, as have courts in prior cases, that the result we reach today "'smacks of injustice'" because petitioners are, in effect, denied the benefit of a deduction for Mr. Biehl's attorney's fee. Kenseth v. Commissioner, 114 T.C. 399, 407 (2000) (quoting Alexander v. Commissioner, 72 F.3d at 946), affd. 259 F.3d 881 (7th Cir. 2001). However, the injustice is the direct result of the plain meaning and original intent of section 62(a), with its built-in disparity in treatment of Schedule C expenses and employee expenses, and the mechanical operation of the itemized deduction provisions of sections 67 and 68 and the AMT provisions. Petitioners' efforts to circumvent the business connection requirement built into section 62(a)(2)(A) and to avoid the restrictions on the deductibility of itemized deductions must fail. We conclude in this case, as we have in prior cases, that it is the job of Congress, if it should decide in its wisdom to do so, to cure the injustice. Kenseth v. Commissioner, supra at 407-408. We sustain respondent's determination.

Decision will be entered for respondent.